

**DOCUMENT OF THE EUROPEAN BANK  
FOR RECONSTRUCTION AND DEVELOPMENT**

# **STRATEGY FOR AZERBAIJAN**

As approved by the Board of Directors on 18 September 2007

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## ABBREVIATION LIST

<b>ACG</b>	Azeri-Chirag-Guneshli
<b>ADB</b>	Asian Development Bank
<b>ADDY</b>	Azerbaijan State Railways
<b>AIC</b>	Azerbaijan Investment Company
<b>AZN</b>	Azerbaijani Manat
<b>BAS</b>	Business Advisory Service
<b>BMZ</b>	Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung - German Federal Ministry for Economic Cooperation and Development
<b>bpd</b>	barrels per day
<b>BTC</b>	Baku-Tbilisi-Ceyhan oil pipeline
<b>CDM</b>	Clean Development Mechanism
<b>CEAF</b>	Central Asia Small Enterprise Fund
<b>CEC</b>	Central Electoral Commission
<b>CIS</b>	Commonwealth of Independent States
<b>CPI</b>	Corruption Perceptions Index
<b>DEG</b>	Deutsche Investitions and Entwicklungsgesellschaft
<b>DIF</b>	Direct Investment Facility
<b>DLF</b>	Direct Lending Facility
<b>EC</b>	European Commission
<b>EIA</b>	Environmental Impact Assessment
<b>EIB</b>	European Investment Bank
<b>EITI</b>	Extractive Industry Transparency Initiative
<b>ENP</b>	European Neighbourhood Policy
<b>ETCI</b>	Early Transition Country Initiative
<b>ETCF</b>	Early Transition Countries Fund
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment

<b>FI</b>	Financial Institutions
<b>GDP</b>	Gross Domestic Product
<b>GUAM</b>	Georgia, Ukraine, Azerbaijan, Moldova
<b>IBA</b>	International Bank of Azerbaijan
<b>IBRD</b>	International Bank for Reconstruction and Development
<b>IDA</b>	International Development Association
<b>IDP</b>	Internally Displaced Person
<b>IFI</b>	International Financial Institution
<b>IFRS</b>	International Financial Reporting Standards
<b>ILO</b>	International Labor Organization
<b>IMF</b>	International Monetary Fund
<b>IOSCO</b>	Objectives and Principles of Securities Regulations
<b>JBIC</b>	Japan Bank for International Cooperation
<b>JFPR</b>	Japan Fund for Poverty Reduction
<b>JICA</b>	Japan International Cooperation Agency
<b>KfW</b>	Kreditanstalt für Wiederaufbau und Entwicklung
<b>MCFF</b>	Medium Sized Co-Financing Facility
<b>MCIT</b>	Ministry of Communications and Information Technology
<b>MENR</b>	Ministry of Ecology and Natural Resources
<b>MP</b>	Member of Parliament
<b>MSE</b>	Medium Sized Enterprises
<b>MSME</b>	Micro, small and medium enterprises
<b>NBA</b>	National Bank of Azerbaijan
<b>NEAP</b>	National Environmental Action Plan
<b>NIP</b>	National Indicative Programme
<b>NOSCP</b>	National Oil Spill Contingency Plan
<b>ODIHR</b>	Office for Democratic Institutions and Human Rights
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>OSCE</b>	Organisation for Security and Co-operation in Europe

<b>PIU</b>	Project Implementation Unit
<b>PSP</b>	Private Sector participation
<b>SCP</b>	South Caucasus Pipeline
<b>SCS</b>	State Committee for Securities
<b>SEA</b>	Strategic Environmental Assessment
<b>SEP</b>	Sustainable Energy Programme
<b>SME</b>	Small or medium enterprise
<b>SOCAR</b>	State Oil Company of Azerbaijan Republic
<b>SOFAZ</b>	State Oil Fund of Azerbaijan Republic
<b>SPPRSD</b>	State Programme on Poverty Reduction and Sustainable Development
<b>SRO</b>	Self Regulatory Organisation
<b>TA</b>	Technical Assistance
<b>TAM</b>	TurnAround Management
<b>TC</b>	Technical Cooperation
<b>TFP</b>	Trade Facilitation Programme
<b>TRACECA</b>	Transport Corridor Europe Caucasus Central Asia
<b>UN</b>	United Nations
<b>USAID</b>	United States Agency for International Agency
<b>USTDA</b>	United States Trade and Development Agency
<b>WB</b>	World Bank
<b>WTO</b>	World Trade Organisation

## EXECUTIVE SUMMARY

Azerbaijan is committed to and is making progress towards implementation of the principles of Article 1 of the Agreement Establishing the Bank. The economic advancement of the country has been visible and acknowledged while progress in transition to multi-party democracy and pluralistic society has been slow, with many challenges remaining. According to international observers, the presidential elections of October 2003 and the last parliamentary elections, which took place in November 2005, fell short of a number of OSCE commitments, although some progress was noted in comparison with previous elections. The next presidential elections, due in October 2008, will provide an opportunity for demonstrating progress in ensuring freedom of the media and functioning of democratic institutions.

The economy has fundamentally changed since the increase in oil production and opening of the Baku Tbilisi Ceyhan (BTC) pipeline. While the average economic growth was around 10 per cent during 2002-2005, the real GDP grew at more than 26 per cent in 2005 and reached an unprecedented 35 per cent in 2006, making Azerbaijan the fastest growing economy in the world. The dramatic growth has resulted in a more than two fold increase in GDP per capita over the last two years. Increased oil production and exports together with high prices, created an economic structure that is more than ever focused on oil. Currently the oil sector accounts for about 54 per cent of GDP and three quarters of industry. The non-oil sector also grew by about 12 per cent on average in the past two years partly reflecting spill over effects from oil and gas, especially in the machinery, chemical industry, construction, and telecommunication sectors.

The high oil revenues have had macroeconomic consequences. The fiscal position of Azerbaijan continued to strengthen in the past two years. Budget revenues increased by two third in 2006, allowing a large increase in public spending, mainly in infrastructure investments. The current account switched from a large deficit of 30 per cent in 2004 to a large surplus of 16 per cent in 2006, due to the dramatic increase in oil exports and a reduction in construction-related imports once the major export pipelines were completed. However, the large increase in oil exports, growth in domestic demand and continued wage increases have exerted upward pressure on monetary growth. The result has been a continued increase in inflation, which reached about 11.4 per cent at the end of 2006 and more than 16 per cent in March 2007 from 5.4 per cent at the end of 2005. The real exchange rate appreciated by about 10 per cent per year during the past two years raising concerns about the loss of competitiveness of the non-oil sector.

There is evidence from around the world that resource wealth makes economic reform more difficult and Azerbaijan is no exception. The progress with structural reforms has been uneven. The government has taken significant steps to raise energy prices toward international levels with the latest major price increase implemented in January 2007. The transparency of resource revenues has improved as Azerbaijan was the first country under the Extractive Industry Transparency Initiative (EITI) to submit an internationally audited progress report. Similarly, the authorities have shown willingness for transparent public procurement procedures in recent infrastructure projects supported by the EBRD. Some initial steps have been taken to improve the business environment including efforts to simplify business registration.

The business environment in the non-oil and gas sectors, however, continues to require significant improvement. The complex tax and customs system, bureaucratic delays and corruption continue to be major obstacles to the development of private enterprises, particularly those in the non-oil sector. Although the anti-corruption law became effective in January 2005, the Anti-corruption Commission has been slow in implementing it. Azerbaijan was ranked 99th out of 175 countries by the World Bank's Doing Business survey in 2006, an improvement of only one place from 2005. Monopolies continue to hamper competition, while cases of government intervention with investments in the non-oil sector have had a negative impact on investors' confidence. A new law on investment activity

intended to set a level playing field for domestic and external investors has been delayed and is currently under discussion. The level of foreign direct investment in the non-oil sectors of the economy remains low.

An economy that is so highly dependent on the energy sector is vulnerable to energy shocks. Economic diversification is therefore essential for long term sustainability. The recent large increase in public expenditure of 80 per cent in 2006 and an expected 50 per cent in 2007 raise concerns not only about further inflationary and exchange rate pressures, but also over general absorption capacity and long-term sustainability of public finances given the expected decrease of oil production in the medium term. In the context of substantial oil revenues the government's major challenge is to maintain macroeconomic stability while efficiently addressing large investment needs and incidence of poverty in the country. This would require designing a long term budget expenditure policy (in terms of size and composition of expenditure), and an effective public investment management program that is aimed at improving the investment climate, increasing competitiveness of the non-oil sector, and establishment of efficient infrastructure.

In 2006, Azerbaijan and EU adopted an Action Plan within the EU's European Neighbourhood Policy (ENP) framework and signed a memorandum on strategic partnership on energy issues. Both the ENP Action Plan and the country's ongoing WTO entry negotiations are expected to encourage reforms.

Azerbaijan continues to face major challenges which include:

- improving the business environment through sustained anti-corruption measures, strengthening administrative capacity, enhancing the regulatory environment and the rule of law in order to create a level playing field conducive to further development of local private enterprises and attraction of foreign investment.
- developing the non-oil and gas sectors of the economy to ensure poverty alleviation and sustainable development throughout the country including rural areas and cities outside the capital through long-term economic policies and incentive schemes.
- further reforming and strengthening of the financial sector as an effective tool for channelling oil revenues into non-oil sectors and supporting diversification of the economy for sustainable future growth.
- restructuring of the public infrastructure sector and continued investments to improve efficiency and service standards in transport, telecommunications, electricity, gas, water, sewerage, waste treatment, as well as cleaning the heavily polluted environment.
- efficient long-term management of oil and gas revenues and ensuring macroeconomic stability through prudent monetary and fiscal expenditure policy to avoid excessive inflationary pressure and real exchange appreciation.

As of 30 April 2007, the Bank has committed a cumulative amount of €720 million to support 80 country and regional projects covering a wide range of sectors including energy, transport, water, banking, property, agribusiness, and general industry. The net portfolio stands at €461 million. The private sector ratio is 52 per cent of the net portfolio.

The Bank's approach over the next strategy period, taking into account the challenges facing Azerbaijan, will be to support transition towards an open market-oriented economy via economic diversification and creating conditions conducive to long-term sustainable development. The Bank will in particular:

- engage actively in further sector reforms working with both public and private sectors, and continue policy dialogue with the authorities to improve the investment climate.

- support the corporate sector, working with local entrepreneurs, local banks, and foreign investors, with a focus on diversification of the economy into the non-oil and gas sectors including rural development, and improvement of industry standards to an international level.
- continue its leading role in developing the banking sector, enhance further competition, stimulating access to financial services in rural areas, and develop non-bank financial services.
- increase its role in financing key infrastructure projects focusing on transport, energy, and environmental clean-up, supporting capacity building, encouraging private sector participation through sector restructuring, and supporting potential Public-Private Partnerships.

The Bank's main operational objectives over the coming strategy period are as follows:

1. **Enterprise sector** – The Bank will contribute to the development of the non-oil sector by making direct debt and equity investments and via support to the financial sector. Particular emphasis will be on SMEs and micro enterprises, fully utilising tailored instruments, resources and programmes including direct equity for local enterprises and non-bank micro-finance institutions, as well as through traditional tools such as credit lines via local banks and the trade facilitation programme. In addition, the Bank will support medium-size enterprises together with local banks through co-financing. The SME sector will be further strengthened through the TurnAround Management (TAM) and Business Advisory Services (BAS) programmes. The Bank will also seek opportunities for larger scale debt and equity investments alongside local and foreign investors, and work as appropriate with the newly established state-owned Azerbaijan Investment Company (AIC) to encourage investments in the non-oil sector. The Bank will promote improved standards of corporate governance, integrity, adequate financial disclosure and transparency of ownership in the corporate sector.
2. **Financial sector** – The Bank will continue its support to existing and new partner banks in Azerbaijan by providing credit lines, syndicated and subordinated loans, equity investments and trade instruments with the objective of developing larger, more diversified and sustainable banks. A special emphasis will be on provision of financial resources to regions outside Baku through the banks' expanding branch networks and providing increased support to the agriculture sector. The Bank will continue encouraging competition and consolidation among local banks, and will support foreign investments in the banking sector. Additionally, the EBRD will support the further development of non-bank microfinance institutions as well as leasing and insurance companies. The EBRD investments in the sector will be supplemented by substantial technical assistance for capacity building of local financial institutions.
3. **Infrastructure and Energy** – Azerbaijan's infrastructure sector suffers from chronic underinvestment in the past, deferred maintenance and a weak regulatory environment. The current level of basic infrastructure and lack of significant sector restructuring hinders economic recovery, jeopardises the country's competitiveness and reduces the likelihood of attracting quality foreign investors. Notwithstanding the cheaper and more flexible sources of finance now available to Azerbaijan, the Bank, at the request of the Government, is expected to play an important and bigger role in the large infrastructure investments planned for the medium term, in line with Azerbaijan's goal to become a transit country between Central Asia and Europe. The Bank is already taking a lead in policy dialogue with the Government particularly in the power sector and will help drive key sector reforms, legislative and regulatory changes, and attraction of the private sector. The key factor for the Bank's involvement will be its impact in terms of transparent procurement practices, specific technical assistance, implementation capacity building, commercialisation of state-owned enterprises, advice on sector reforms, and experience in the introduction of the private sector. The Bank's focus in the coming period will be on transport with a particular focus on the east-west and north-south transit corridors (railways, roads, ports, aviation, and transport logistics), energy (power generation and transmission, gas

storage and transport, energy efficiency), municipal infrastructure (solid waste collection and disposal), and environmental clean-up (in particular energy related contamination). Given the large increase in public revenues and availability of financial resources from various international sources, the Bank will be selective in the specific sub-sectors on which it will focus in coordination with the Government and multilateral financial institutions. The Bank will work closely with the EU, EIB and the Azerbaijani authorities to co-finance projects, and ensure coordination with other IFIs, noting in particular the Memorandum of Understanding between the European Commission, in liaison with the EIB, and the EBRD signed in December 2006.

The Government's ability, commitment and willingness to undertake structural reforms are crucial for the successful implementation of the proposed strategy. The Bank will continue and enhance its policy dialogue with the authorities in coordination with the local and foreign business community, other IFIs, EC, and bi-lateral donors. Through this dialogue, the Bank will aim to assist improving the business environment, laying the foundations for long-term economic diversification, channelling growth into rural areas and secondary cities, strengthening the banking sector, and fostering regulatory reforms. In this respect, the Bank will seek from donors to increase its stand-alone technical assistance for advisory support management services (TAM and BAS), legal transition assignments and capacity building for various state agencies.

## COUNTRY STRATEGY

### 1. THE BANK'S PORTFOLIO

#### 1.1 Overview of Bank Activities to Date

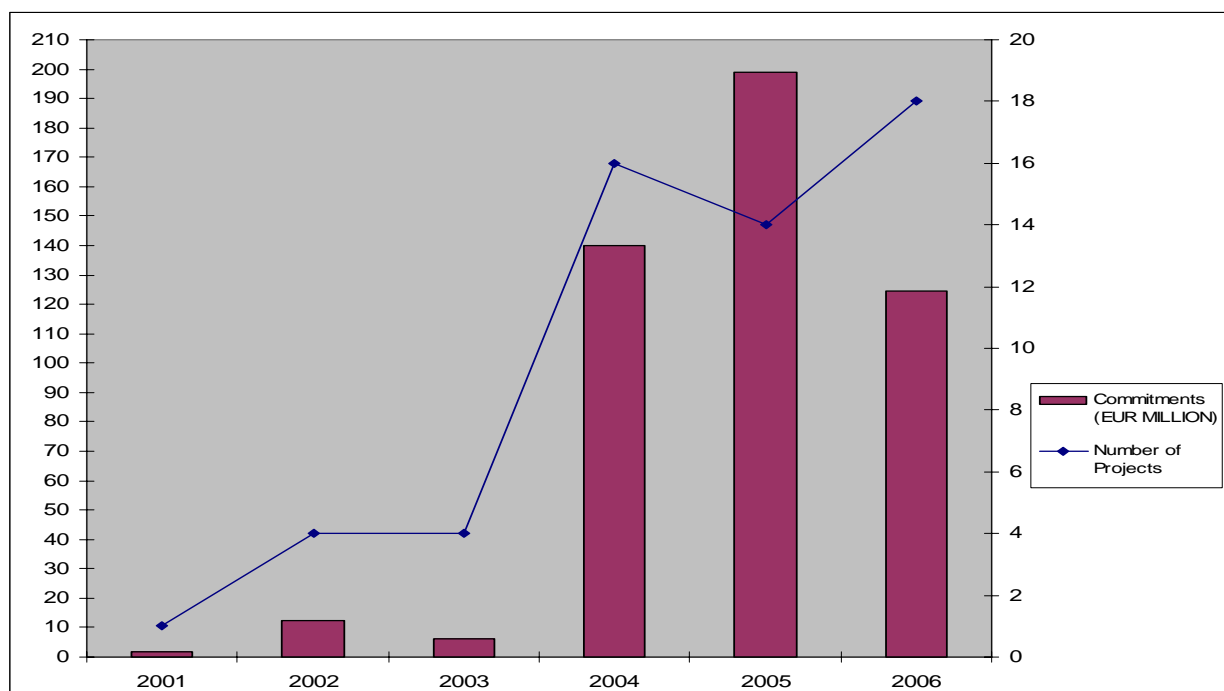
As of 30 June 2007 the Bank had signed 80 country and regional projects with a cumulative business volume of €739.1 million covering natural resources, energy, transport, financial institutions, agribusiness, property, and general industry. Net portfolio was €482.4 million with operating assets of €162.6 million.

The natural resources sector dominates the Bank's portfolio, representing 32.7 per cent of total portfolio, as the Bank supported several large projects in oil and gas production as well as construction of key transport pipelines. The Bank signed three projects in the power and energy sector (two already completed), which cumulatively account for 21.0 per cent of the Bank's portfolio. Rehabilitation of basic infrastructure is another important area which constitutes 26.9 per cent of the Bank's total portfolio in Azerbaijan with a particular focus on transport projects. In parallel, the Bank took a lead role in supporting the growth of local financial institutions through debt, equity and trade facilitation programmes although this sector represents only 15.7 per cent of total portfolio, consisting of many relatively small size transactions given the low capital base of local partner banks. The Bank's financing to the enterprise sector (specialised and general industries) amounts to 3.7 per cent of its total portfolio, a reflection of the small size of the non-oil and gas sectors and the difficult business environment.

**Table 1: Commitments and Net Portfolio as of 30 June 2007 (in €million)**

Sector	Commitments					Net Portfolio				
	No. of projects	Total Project Cost	EBRD Funding	% of total EBRD	Disbursed	No. of projects	Portfolio	% of Portfolio	Undrawn commitment	Operating assets
<b>Financial Institutions</b>	<b>46</b>	<b>115.5</b>	<b>87.8</b>	<b>11.88</b>	<b>56.1</b>	<b>41</b>	<b>75.7</b>	<b>15.69</b>	<b>29.9</b>	<b>46.2</b>
<b>Infrastructure</b>	<b>6</b>	<b>240.5</b>	<b>146.4</b>	<b>19.81</b>	<b>61.4</b>	<b>3</b>	<b>129.8</b>	<b>26.91</b>	<b>84.9</b>	<b>44.8</b>
<i>MEI</i>	<i>1</i>	<i>80.6</i>	<i>16.8</i>	<i>2.27</i>	<i>16.8</i>	<i>1</i>	<i>4.6</i>	<i>0.95</i>	<i>0</i>	<i>4.6</i>
<i>Transport</i>	<i>5</i>	<i>159.9</i>	<i>129.6</i>	<i>17.53</i>	<i>44.6</i>	<i>2</i>	<i>125.2</i>	<i>25.95</i>	<i>84.9</i>	<i>40.2</i>
<b>Energy</b>	<b>19</b>	<b>3534.7</b>	<b>481.3</b>	<b>65.12</b>	<b>284.7</b>	<b>13</b>	<b>259.3</b>	<b>53.75</b>	<b>196.6</b>	<b>62.7</b>
<i>Natural Resources</i>	<i>16</i>	<i>3,348.3</i>	<i>340.8</i>	<i>46.11</i>	<i>229.3</i>	<i>10</i>	<i>157.8</i>	<i>32.71</i>	<i>111.5</i>	<i>46.3</i>
<i>Power and Energy</i>	<i>3</i>	<i>186.4</i>	<i>140.5</i>	<i>19.01</i>	<i>55.4</i>	<i>3</i>	<i>101.5</i>	<i>21.04</i>	<i>85.1</i>	<i>16.4</i>
<b>Specialised Industry</b>	<b>7</b>	<b>21.8</b>	<b>14.6</b>	<b>1.98</b>	<b>5.8</b>	<b>2</b>	<b>9</b>	<b>1.87</b>	<b>8.5</b>	<b>0.6</b>
<i>Agribusiness</i>	<i>4</i>	<i>9.3</i>	<i>9.0</i>	<i>1.22</i>	<i>0.2</i>	<i>2</i>	<i>9.0</i>	<i>1.87</i>	<i>8.5</i>	<i>0.6</i>
<i>Property and Tourism</i>	<i>3</i>	<i>12.5</i>	<i>5.6</i>	<i>0.76</i>	<i>5.6</i>	<i>0</i>	<i>0</i>	<i>0.00</i>	<i>0</i>	<i>0</i>
<b>General Industry</b>	<b>2</b>	<b>13.0</b>	<b>9</b>	<b>1.22</b>	<b>1.2</b>	<b>2</b>	<b>8.6</b>	<b>1.78</b>	<b>0.7</b>	<b>7.9</b>
<b>Country Total</b>	<b>80</b>	<b>3,925.5</b>	<b>739.1</b>	<b>100</b>	<b>409.2</b>	<b>61</b>	<b>482.4</b>	<b>100</b>	<b>320.6</b>	<b>162.2</b>

**Graph 1: Annual Business Volume and Number of Transactions (including regional)**



For a more detailed overview of the Bank's projects, see Annex 4.

## 1.2 Implementation of the Previous Country Strategy

The main objectives of the Bank's previous strategy were to: (i) support private sector development in the non-oil sector with a focus on micro, small and medium-sized enterprises; (ii) help strengthen the financial sector; (iii) contribute to the creation of efficient infrastructure, with a focus on power and transport; and (iv) shift focus to smaller on-shore projects with environmental components in the natural resources sector.

- **Enterprise Sector:** The Bank has increased its support to the non-oil sector both directly and through local banks. Extensive business development activity, which included screening of more than 30 private sector projects, helped the Bank to deepen its sector knowledge and better understand the systemic obstacles for local enterprises. As a result of this effort, two MCFE projects were signed in the beginning of 2007. The Bank has also provided support to the Business Advisory Services (BAS) operations in Azerbaijan since 2003, which has implemented over 330 projects, funded by the EBRD Early Transition Countries Fund (ETCF) and previously by EuropeAid with a total of over €1.9 million utilized. Under Canadian funding, BAS has also carried out Women in Business programmes providing direct support to women entrepreneurs through tailor-made consultancy projects, workshops and seminars, organised according to country specific demand. The TAM Programme, supporting larger enterprises, has undertaken 21 projects in Azerbaijan since 1998, utilizing over €1.4 million from various bilateral donors and the ETCF. Several of these TAM and BAS projects have in turn led to the identification of companies suitable for Bank financing. Finally, the Bank continued its efforts to support foreign direct investment in the non-oil sector, and took an equity participation in the largest cement producer of Azerbaijan, owned by a Swiss parent. At the request of the Azerbaijani Government, the EBRD has provided technical assistance to the Azerbaijan Investment Company (AIC), a state-owned institution established in 2006 with a mandate to channel oil revenues into non-oil sector development. The funding was used for appointing an experienced consultant who assisted AIC in preparing its charter and the investment assessment, approval and monitoring procedures (please see Annex 6 for more information on AIC).
- **Financial Institutions:** The Bank continued to play a lead role in the development and strengthening of the banking sector through direct shareholding, various debt products and trade

facilitation programmes, and substantial technical assistance funded by donors. In the banking sector, the Bank signed SME and MSME credit lines increasing the volume of its support threefold in the past two years. The Bank also expanded the number of participating banks from 3 to 9 since 2003, reaching a wider geographic coverage through expanding branch networks supporting 118 local SMEs and more than 3,500 MSEs. Through two syndicated loans in 2005 and 2006, the Bank facilitated the introduction of a local bank to international markets, with a positive demonstration effect for the rest of the sector. In addition to continued support to Microfinance Bank of Azerbaijan, the Bank also started co-operation with two other non-bank microfinance institutions (Finca and CredAgro) that are lending to the smallest clients across the country and particularly in the rural areas. The Bank signed its first projects in insurance and leasing sectors, €0.6 million equity investment in MBASK Insurance, and €0.5 million equity and €2.2 million debt financing for Unileasing. One of the major contributions of the Bank to the relatively weak but fast growing local banking sector during the previous strategy period has been targeted donor-funded technical assistance for capacity building and institutional development. The introduction of sound banking principles and enhanced corporate governance through technical assistance and equity participations allowed the local banks to access additional sources of finance.

- **Infrastructure:** The Bank focused its efforts in the **transport** sector during the past strategy period, in line with Government priorities and the urgent need to provide a sound road and railway infrastructure conducive to non-oil private sector development. The implementation of the €14.8 million loan to enable the Azerbaijan State Railways (ADDY) to rehabilitate and modernise parts of the trans-Caucasian railway line and to improve the efficiency and environmental performance of its oil tanker wagon washing facilities (Balajari Washing Plant) was completed in October 2005. This was the first project which was financed in the railway sector by an IFI, and resulted in substantial transfer of know-how in project preparation, international competitive tendering, project implementation and monitoring within ADDY. The €30 million Hajigabul-Kurdamir road project, which is part of the east-west transport corridor, is under construction with the support of international technical consultants mobilised as part of the project. In 2005, the Bank committed an additional €73.3 million for the construction of a road project linking Baku to the Russian border which is in a poor state of disrepair. The transition aim of this project is to achieve further commercialisation of the road sector through adoption of a new organisational structure and establishment of a roads board.
- **Energy:** In the **power** sector, the Bank signed a €84.3 million loan at the end of 2006 for the rehabilitation of Azdres Thermal Power Plant, the largest power generation source supplying roughly half of electricity consumed in Azerbaijan. As part of the project, the Bank also mobilised grant funding for technical assistance to help build capacity of the Tariff Council, improve health and safety standards at Azerenerji, the national electricity utility, and environmental improvements related to Azdres rehabilitation. In addition, this is the first project in Azerbaijan which may benefit from carbon credits utilising the Clean Development Mechanism (CDM) established under the Kyoto Protocol and help support energy efficiency in accordance with the Bank's Sustainable Energy Programme (SEP). The Bank played a key role in the development of the **oil and gas** sectors of Azerbaijan, contributing to the generation of substantial foreign exchange revenues and record economic growth during the past strategy period. The Bank participated in the upstream development of the Azeri-Chirag-Guneshli (ACG) oil and Shah Deniz gas fields, as well as the trans-border Baku-Tbilisi-Ceyhan (BTC) oil and South Caucasus Pipeline (SCP) gas pipelines. Azerbaijan's oil exports have increased to 600,000 barrels per day (bpd) as a result of the completion of BTC in July 2006, and are expected to reach 850,000 by end-2007 and 1 million bpd by 2009. The Bank also financed the participation of the State Oil Company of the Azerbaijan Republic (SOCAR) in the Shah Deniz Gas Field development. The Bank provided technical assistance to SOCAR, funded by USTDA, which undertook a detailed analysis of existing operations and led to recommendations on corporate reorganisation, financial disclosure and commercialisation. In 2006, however, SOCAR obtained a \$750 million five-year syndicated loan and prepaid its outstanding loans to the Bank. This was the largest ever syndicated financing for an Azeri-controlled company, and the first sizeable deal for the country not backed by a state guarantee or an export credit agency. Despite prepayment of the Bank's loan, SOCAR is currently implementing some of the above mentioned recommendations and has recently signed a major contract with an international audit firm to

train staff and produce financial statements in accordance with IFRS. Azerbaijan continues to make progress in further developing the institutional framework for responsible management of its oil and gas revenues. Azerbaijan is playing a key role in the Extractive Industries Transparency Initiative (EITI), and the State Oil Fund of Azerbaijan Republic (SOFAZ) continues to build capacity internally and function in an increasingly transparent manner. In recognition of its achievements, SOFAZ has been awarded the 2007 UN Public Service Award in the category of “Improving transparency, accountability and responsiveness in the Public Service”.

### 1.3 Transition Impact of the Bank’s Portfolio and Lessons Learned

#### 1.3.1 Quality of Portfolio

The current net portfolio (as of 30 June 2007) stands at €482.4 million, an increase of 34 per cent over the previous strategy period. On the other hand, the operating assets decreased by 53 per cent to €62.2 million due to the prepayment of two large loans to SOCAR.

The overall portfolio risk rating is 5.92, compared with 5.48 for the Bank as a whole. The Bank’s portfolio in the natural resources sector has a risk rating of 5.0 and investments in equity funds - 4.1, while it is in excess of 6.0 in all other sectors, reflecting a vulnerable portfolio in the difficult non-oil business environment. The performance of operating assets is excellent with no impaired assets. The level of undrawn commitments is still high with 66.4 per cent of total net portfolio at the end of June 2007. This is mainly due to two large infrastructure projects signed in 2005 and 2006 which are currently under design and tendering stages, with disbursements expected to accelerate in 2007 and 2008.

#### 1.3.2 Mobilisation of Co-financing

The majority of the Bank’s co-financing in Azerbaijan has taken place in the large oil and gas projects as well as financial institutions and property and tourism sectors. To date, the Bank has mobilised a total of €21.2 million in commercial co-financing from sponsors and co-financiers for a mobilisation ratio of 47.8 per cent (the EBRD direct financing was €32.4 million for the same projects). This included €106.9 million for three projects in oil and gas production and transportation, €10.2 million in two syndicated loans to a local bank, an equity investment in a microfinance bank, as well as €4.1 million in three projects in the property and tourism sector.

#### 1.3.3 Transition Impact and Lessons Learned

##### 1.3.3.1 The Enterprise Sector

**Agribusiness:** The Bank invested both equity and loan in 2004 in a dynamic local dairy company (MilkPro) in order to expand its production capacity and construct a new facility outside Baku. The project is expected to contribute to the expansion of the dairy sector with improved hygiene and quality standards, although its full impact cannot yet be assessed. The Bank has also signed a €3.5 million loan under DLF to Taj Aqua Vita, a local water and drinks producer. The loan will assist the company to expand its capacity and increase the assortment of its products. **A lesson learned** from these investments is to avoid complex financial and security structures especially with relatively small and inexperienced clients.

**Property and Tourism:** The Bank financed the staged development of an office complex and an ex-brownfield site towards “class A” office estates in Baku. In addition, policy dialogue with the Government aimed to facilitate the development of modern mortgage legislation and a functioning registry, however, so far without success. **A lesson learned** in the Landmark I (Neptun) project is that TC projects, which pursue institutional reforms in the property sector in corrupt environments need support and parallel programmatic assistance from other donors (e.g. World Bank) to be successful (PE05-316).

Overall, transition impact within the *Enterprise Sector* is rated *Moderate*.

### **1.3.3.2 The Financial Sector**

**Banking:** The Bank has taken a leading role in the development of the banking sector in Azerbaijan. Its equity investments in particular have directly contributed to higher standards for corporate governance, competition has increased, and the sector became more attractive to foreign investors, some of which demonstrate concrete plans for entering Azerbaijani market. Nevertheless, privatisation of the state-owned International Bank of Azerbaijan, which accounts for about half of the sector, is delayed and further consolidation is required among smaller banks. Should they proceed, the Bank will monitor IBA, Kapital Bank and other privatisation efforts, and to the extent possible, facilitate the process. In addition, the Bank will actively encourage mergers and acquisitions with the objective of developing strong and competitive market players capable of providing competitive banking products and services.

**Non-bank financial institutions:** The Bank acquired a 30 per cent stake in a small private insurance company (MBASK) in 2005. The investment and supplementary TC had the objective to improve corporate governance, introduce internationally accepted insurance practices and to enhance competition overall. It is, however, too early to judge the impact of this transaction and to draw consequent lessons learned. The Bank has also provided debt and equity financing to Unileasing in early 2007, a subsidiary of Unibank in the leasing sector.

**SMEs and MSMEs:** The Azerbaijan Multi-bank Framework Financing Facility supports micro-, small- and medium enterprises through a number of local banks. Capital demand in the sector is high, and led to two facility extensions in 2005 and 2006 up to the total amount of \$80 million. By expanding the number of participating banks to 9, through institutional strengthening, provision of term funding, introduction to international markets, the Bank helped effectively crystallise the group of leading private banks in the country. In late 2006, the EBRD has provided loans to two micro-financing institutions operating primarily in the rural areas. Still, the business climate in non-oil sectors is poor and particularly SMEs suffer from bureaucratic hurdles in registration, tax administration, and customs, as well as high levels of corruption.

Overall, transition impact within the *Financial Sector* is rated *Significant*.

### **1.3.3.3 Infrastructure and Energy**

**Transport:** Financial engagement with the Azerbaijan State Railways helped to enhance physical and economic viability of the Transcaucasian Railway Route and achieved good transition impact benefiting the whole railway organisation.

**Power:** The Bank provided a loan to Azerenerji, the state-owned power utility, for the rehabilitation of the 300 MW dual fuel fired Azdres thermal power plant. Continuing policy dialogue helped the Government to initiate the transfer of electricity distribution systems to long-term private management by starting with three networks, which has not been a successful example of a concession. **The lessons learned** from this case based on previous experience are: 1) the importance of an appropriate legal framework prior to starting privatisation in the power sector, and 2) the importance to set realistic target prices for liberalisation ensuring they will be politically tenable (PEX03-185).

**Natural resources:** The development of the Chirag and Guneshli production areas offshore had significant demonstration effects attracting other investors in the oil sector. In terms of policy dialogue, state authorities have been encouraged to adopt new procedures for enhancing transparency and environmental protection. Despite all achievements in the oil sector, the development of the non-oil sector has lagged behind. **A lesson learned** here, is to focus on generating spill-over effects to the local industry from large foreign investments. This could be realised e.g. through stimulating procurement of high-quality goods from domestic suppliers (PE01-171).

Overall, transition impact within the *Infrastructure and Energy Sector* is rated *Moderate to Significant*.

## **1.4 Portfolio Ratio**

During the strategy period the percentage of investments in private sector projects increased from 49 per cent to 53 per cent of the Bank's portfolio, reflecting the Bank's strategy for continued support to

both public and private sectors. It is expected that the private sector portfolio may actually decrease during the next strategy period given the individual size of sovereign infrastructure projects in the pipeline. A large majority of the projects the Bank expects to sign, however, will be private sector projects which are relatively small in size in line with the current scale of the corporate and financial sectors.

## **2. OPERATIONAL ENVIRONMENT**

### **2.1 The General Reform Environment**

#### **2.1.1 Political Environment**

Azerbaijan has an important geo-strategic position, linking resource-rich Central Asia and Caspian Sea basin with Europe. Neighbouring Russia and Iran and bordering Georgia, Armenia and Turkey, the country is bound to consider many geopolitical interests.

According to the Constitution of 1995, Azerbaijan is a presidential republic, based on the principle of separation of powers. Strong executive branch of power is concentrated in the presidency. The President is directly elected for a five-year term. The next presidential elections are due in October 2008.

In the last two years, sizeable economic advancement has been achieved but transition to a pluralistic democracy was slower, with many challenges remaining in implementing the rule of law, maintaining freedom of the media and ensuring respect for individual human rights.

Azerbaijan is balancing its foreign policy orientations, striving to maintain good relations with the US, EU and its immediate neighbours. Last year the country adopted an important Action Plan within the EU's European Neighbourhood Policy (ENP) framework and a memorandum on strategic partnership with the EU on energy issues. Further political assessment is provided in Annex 1.

#### **2.1.2 Economic Environment**

Since the last strategy, the structure of the economy has changed significantly due to the increase in oil production and exports. The economic growth has seen the highest historic figures to date. Real GDP growth reached a record 34.5 per cent in 2006 after a growth of 26.4 per cent in 2005, reflecting increases in oil production, high oil prices and exports and large, although declining, capital investments. The oil sector accounted for about 54 per cent of GDP in 2006 (up from 44 per cent in 2005) and more than three quarters of industrial sector, underpinning the growth of industry as a whole by about 55 per cent. Agriculture, which accounts for only about 7 per cent of GDP, down from about 11 per cent in 2004, expanded by around 1 per cent in 2006. The trend of record growth has continued in the first half of 2007. During the first half of 2007, GDP growth is estimated at 35.1 per cent. The economy is highly dependent on the energy sector, however, and it is vulnerable to energy shocks. Therefore, economic diversification is essential for long term sustainability. High oil prices have had some positive spillover effect on the development on non-oil sector that grew at about 12 per cent in the last two years, especially transport and construction. However, despite the soaring growth, the oil sector is not generating significantly more employment or encouraging additional economic activity outside the capital. It is estimated that the industry outside of energy sector is utilised only at 40 per cent of its capacity. Foreign investment flow into the non-energy sectors is very low.

The surge in oil exports and the subsequent increase in domestic demand as well as wages are exerting upward pressure on monetary growth. Money supply and credit rose sharply in the past two years, fuelling inflation. As a result, annual inflation continued to increase reaching 11.4 per cent in end-2006, up from 5.4 per cent in end-2005. As the inflationary pressure continues to mount with the increase in oil exports and consequent increase in domestic demand, the National Bank of Azerbaijan (NBA) abandoned the de facto fixed exchange rate to the US dollar in February 2005 and allowed the manat to appreciate in real terms. NBA has also continued to tighten its monetary policy by

repeatedly raising its refinancing rate from 7 per cent in May 2005 to 9.5 per cent in July 2006. Annual inflation was at or above 15 per cent in each of the first six months of 2007 also due to the substantial increase in tariffs in January 2007. In response, NBA increased its discount rate again from 9.5 per cent to 12 per cent at the beginning of April 2007 and further to 13 per cent in June 2007. At the same time, the NBA announced that it will implement an “interest corridor” ranging from 5 per cent to 19 per cent with regards to monetary policy. However, has limited the nominal appreciation of the currency at 5 per cent during 2007. Given the size of the expected rise in export revenues and the limited power of monetary policy instruments in affecting inflation due to an underdeveloped banking sector, controlling inflation will be a major challenge. The real exchange rate appreciated by about 10 per cent annually during the past two years, raising concerns about the possible loss of competitiveness in the non-oil sector – the emergence of “Dutch Disease”.

Budget finance continued to be strong, supported by booming oil income. Government revenues increased by about 68 per cent in 2006 as tax receipts were boosted by high oil prices and production. Subsequently, despite an 80 per cent increase in expenditure, mainly on long-term infrastructure investment, the government budget recorded a surplus of 0.1 per cent of GDP in 2006 (following a 2.4 per cent surplus in 2005). The Government has continued to pursue its strategy of reducing external debt. The gross public external debt to GDP ratio declined to 10 per cent of GDP in 2006 from 18.6 per cent of GDP at end-2004.

Long-term sustainability of public finance underlines the need for intensifying fiscal reforms. Strong oil revenue contributed to a rapid growth of the State Oil Fund assets which reached \$1.28 billion by end-2006, while its expenditures were \$1.10 billion in 2006, with the majority of the outflows transferred to the state budget. With the completion of oil and gas pipelines and likely high oil prices, the government budget will continue to enjoy substantial fiscal revenues in the medium term. The recent large increase in public expenditure of 80 per cent in 2006 and expected 50 per cent in 2007, however, raises some concerns not only over further inflationary and exchange rate pressures, but also over general absorption capacity and long-term sustainability of public finance given the expected decrease of oil production in the medium term.

A careful design of budget expenditure policy in terms of expenditure composition and enhancing of public investment program management is essential in the context of substantial oil revenues and the high incidence of poverty in the country. Public expenditure policy, however, has to take into account the possible excessive real exchange rate appreciation associated with it, which in turn will damage the competitiveness of the non-oil sector. The government’s plans to further liberalise the capital account and trade, as well as improve the business climate in the retail sector, will relieve some of the pressure on real exchange rate. The State Oil Fund is expected to play an important role in financing the public expenditure programs targeted at improvement of human capital and infrastructure in the future.

The switch of the current account from a large deficit to a large surplus is a major change of the past two years. While oil exports surged especially since the second half of 2005, import growth, associated mostly with oil and gas development projects, slowed as major capital investments were completed. This led to a large trade surplus of about 25 per cent of GDP in 2005 and 39 per cent in 2006. Consequently, the current account recorded a surplus of about 16 per cent of GDP in 2006, compared to about 30 per cent deficit in 2004. See Annex 2 for selected economic indicators.

### **2.1.3 Social and Labour Conditions**

The enormous GDP growth in the past two years has contributed to a significant increase of GDP per capita from \$1051 at end-2004 to \$2363 at end-2006. The poverty levels have also decreased, although the proportion of the population living below the “poverty line”, (based on the value of the minimum food basket equivalent to about \$43 per capita a month) remained high at about 29.3 per cent in 2005 (down from 39.7 per cent in 2003), according to a new Household Budget Survey and the World Bank estimates. Although there is only a small difference between poverty levels in rural versus urban areas (47.8 per cent in urban areas and 45.4 per cent in rural areas), there are large regional differences. Baku has the lowest poverty level but due to population concentration in the city, about 25 per cent of all the poor live in Baku. The main source of rural poverty is lack of access to basic services (gas, electricity, heating, water supply) and underdeveloped physical infrastructure,

while urban poverty relates to employment opportunities and wages. Households with more children, with low education level of the head of the household and children under 15 are the most vulnerable groups. The issue of poverty and unemployment is worse for more than half a million Internally Displaced Persons (IDPs), who continue to live in poor conditions in temporary accommodations around Baku and other cities throughout the country. IDPs also suffer from lack of employment opportunities.

To mitigate the effects of higher utility tariffs on those with low incomes, in 2005 the Government prepared the legislative framework for establishing targeted social assistance and started implementing the system in mid-2006. At end-2006 over a quarter of million people received social assistance.

Two major issues in health care and education are access and quality of services. Access to health care is affected by the ability to pay for the poor, in particular due to the incidence of large informal payments caused by the low salaries in the sector. The quality of health care, including buildings, equipment, and medical staff, has suffered from the low level of investments in the sector. Government annual expenditure on health has been below 2 per cent of GDP for the past 5 years. Also, there is a wide inequality in health care service quality between urban and rural areas. The government is taken steps to improve health care in the country. The main priorities include the improvement of primary health care service, improvement in health sector investments, management, and medical education.

The good education system inherited from the Soviet period has suffered from low investments in the past 15 years. This has led to deterioration in the quality of education as wages in the sector are very low. Public spending in education has been below 3.5 per cent in the past few years. The average monthly wage in the education sector in 2006 is about half of the average monthly wage for the whole economy (AZN 78 in education and AZN 67 in health sector compared to AZN 141 in the whole economy). The school enrolment rate for secondary and higher education has suffered due to families' financial inability to support children's education as well as the need that children leave school and work in order to contribute to household income. The net enrolment rate in primary education was 93.2 per cent in 2004, in secondary education about 51 per cent, and in higher education only 9.3 per cent. Access to education is more problematic in rural areas and for girls. The government recognises the issues of lack of access and poor quality of education and is taking measures to improve the quality of curriculum and teachers while ensuring equal access to basic education services.

Recently, the Government is taking actions to develop new employment opportunities, especially for young people, making generation of employment a top priority of the government programme. In cooperation with International Labor Organization (ILO), the Government prepared the Employment Strategy of the Republic of Azerbaijan (2006-2015), which was approved by presidential decree in October 2005. As part of the implementation of the Employment Strategy of the Republic of Azerbaijan, the country has developed a Decent Work Country Programme for 2006-2009 in cooperation with the ILO (signed in end-2006) which advocates promoting opportunities for men and women to obtain decent work in conditions of freedom, equity, security and human dignity. In May 2007, the "Implementation of the Employment Strategy of the Republic of Azerbaijan for 2007-2010" was approved by presidential decree. The main objective of this programme is the improvement of political, economic, social and institutional conditions that will support the development of employment opportunities for the population, as envisaged in the priorities of Employment Strategy of Azerbaijan Republic (2006-2015).

#### **2.1.4 Legal Reforms**

No major legislative reforms have taken place in the country since the last EBRD strategy was adopted in 2005. The quality and implementation of commercial and financial laws continue to create serious challenges to investors. Both the legislation for securities markets and corporate governance was assessed by EBRD as being in "very low compliance" with international standards. Insolvency law remains in "low compliance" with such standards. The Bank's studies on the effectiveness of legal regimes has further confirmed that these areas of law are plagued by a weak institutional environment, one in which courts struggle to fulfil their role, both due to the lack of technical

knowledge and to corrupt practices. In the secured transactions field, the existing legal provisions continue to prevent the development of an efficient market for pledges and mortgages. Various initiatives are being pursued, with foreign technical assistance, to improve the situation although they will require a strong political commitment to come to fruition. The country urgently needs to spend resources and efforts on the improvement of its commercial and financial law framework and of the underlying institutions such as courts and registries. Further details are provided in Annex 3 on legal transition.

### **2.1.5 Environmental Situation**

The geographical location of Azerbaijan, which spreads over 11 climatic zones, accounts for its vast diversity of ecosystems. Azerbaijan has over 4,200 plants species and about 18,000 animal species. An estimated 270 floral species are endemic to Azerbaijan.

Azerbaijan's National Environmental Action Plan (NEAP), as adopted by the Government of Azerbaijan in 1998, has identified the following key environmental issues:

- severe pollution caused by oil exploration and production activities, power sector, and other industries.
- threat of massive reduction of the sturgeon stock and its reproductive capacity caused by over-fishing and illegal poaching and pollution of marine environment by the industries.
- deterioration of water quality in rural and urban areas and an increased risk of the spread of water-borne diseases.
- loss of fertile arable lands due to soil erosion, salinisation and contamination of soil by chemicals, heavy metals and pesticides.
- reduction of forests due to illegal logging, and loss of biodiversity as well as overgrazing.
- damage to the coastal zone of the Caspian Sea triggered by rising sea level as well as environmental pollution.
- deterioration of cultural heritage sites caused by both natural phenomena and uncontrolled development.

Based on identified key environmental problems, NEAP defines environmental priorities and a list of actions. Out of 45 actions, 33 are ranked as top priority. Top priority actions require to be implemented within two to five years and, have specific government agencies assigned responsibilities for their implementation. Although NEAP stipulates that financing for its implementation should be sought from the Government of Azerbaijan, international donors and private enterprises; only a limited number of top priority tasks have been implemented to date.

Environmental Impact Assessments (EIA) in Azerbaijan are conducted in line with the State Ecological Expertise Procedure, as defined in Azerbaijan's Law on Protection of Environment (June 1998). The environmental regulations do not contain any provisions or guidelines for scoping process needed for identifying the scale of environmental risks, order of magnitude and duration of potential impacts, which, in turn, might trigger the requirement to conduct an EIA. The decision on the need to conduct an EIA is determined by the Ministry of Ecology and Natural Resources (MENR) once the project is submitted to MENR for review. The Law of Environmental Protection also contains a notion of the Strategic Environmental Assessment (SEA) although it does not provide any specific guidelines or procedures for its application. Current environmental legislation requires development of mechanisms for effective implementation of its provisions and clear definition of competent authorities and responsibilities for their implementation.

Azerbaijan has signed a partnership and Cooperation Agreement with the European Union, which contains two strategic objectives for Azerbaijan: improving Azerbaijan's national legislation to make it compatible with EU regulations and standards, and development of strategies to address global issues of climate change and sustainable development.

The Bank has recently completed the implementation of a Technical Cooperation Project aimed at assisting the Government of Azerbaijan in developing its National Oil Spill Contingency Plan (NOSCP). A report with detailed recommendations and an outline of the NOSCP have been

submitted to the Ministry of Ecology and Natural Recourses, the Beneficiary of the project. The Government is currently in the process of defining required follow-up steps to adjust the proposed structure of the NOSCP to the existing situation and to develop mechanisms for its implementation.

The Bank will take existing environmental issues into consideration when conducting its environmental due diligence on projects proposed for EBRD funding. Environmental due diligence will aim at identifying the level and scale of potential environmental risks and required mitigation measures, as well as at identifying opportunities for environmental improvements. Required mitigation measures will be included in the Environmental and Social Action Plans and their implementation will be covenanted in the legal agreements on Bank-funded projects. The Bank will continue to expand its environmental monitoring of existing projects, with particular attention to compliance with pertinent national and international environmental regulations and standards and to the implementation of the agreed Environmental and Social Action Plans, especially on large-scale projects like the BTC pipeline, Shah-Deniz gas field development and the South Caucasus Gas pipeline projects.

## 2.2 Progress in Transition and Transition Challenges

### 2.2.1 Progress in Transition

Azerbaijan has made good progress with the first phase of reforms which include price and trade liberalisation and small scale privatisation, comparing well with the rest of the Commonwealth of Independent States (CIS). However, the most difficult reforms that focus on institution building, enterprise restructuring and large-scale privatisation, market liberalisation and competition, and financial sector reform are lagging behind.

Table 2: Transition Indicators of Commonwealth of Independent States (CIS), 2006

Country	Enterprises			Markets and trade			Financial institutions		Infrastructure
	Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalisation	Securities markets and non-bank financial institutions	Infrastructure reform
Armenia	4-	4	2+	4+	4+	2+	3-	2	2+
<b>Azerbaijan</b>	<b>2</b>	<b>4-</b>	<b>2</b>	<b>4</b>	<b>4</b>	<b>2</b>	<b>2+</b>	<b>2-</b>	<b>2</b>
Belarus	1	2+	1	3-	2+	2	2-	2	1+
Georgia	4-	4	2+	4+	4+	2	3-	2-	2+
Kazakhstan	3	4	2	4	4-	2	3	3-	3-
Kyrgyz Republic	4-	4	2	4+	4+	2	2+	2	2-
Moldova	3	3+	2	4	4+	2	3-	2	2+
Russia	3	4	2+	4	3+	2+	3-	3	3-
Tajikistan	2+	4	2-	4-	3+	2-	2+	1	1+
Turkmenistan	1	2	1	3-	1	1	1	1	1
Ukraine	3	4	2	4	4-	2+	3	2+	2+
Uzbekistan	3-	3+	2-	3-	3-	2-	2-	2	2-

Note: The index ranges from 1, indicating little or no progress to 4.3 pointing to standards similar to advanced economies.

Source: EBRD Transition Report, 2006

The progress with structural reforms during the past two years has been uneven, similar to other countries with resource wealth which in turn makes economic reform more difficult. The business environment continues to require significant improvement. Although the anti-corruption law became effective in January 2005, the Anti-corruption Commission has been slow to implement it. Competition is restricted by the existence of monopolies in different sectors of the economy. Governance has been especially weak in the state-owned enterprise sector, which remains highly inefficient and non-transparent. Progress with large scale privatisation has been slow. The separation of commercial and regulatory functions of state-owned enterprises in the telecommunication sector prior to their privatisation is progressing slowly. The banking sector continues to be dominated by the International Bank of Azerbaijan (IBA) and despite some efforts to revive its privatisation, no significant progress was made over the last two years. Although lending by private banks has increased substantially during 2006, IBA continues to own approximately half of all assets in the sector.

Reforms to improve the business environment have recently gathered pace, including efforts to simplify registration procedures for businesses. The authorities plan to further improve customs administration (also as part of the WTO accession process), reduce red tape in the retail sector, and limit price increases by monopolies. A new law on investment activity intended to set a level playing field for domestic and external investors is currently under discussion in the parliament. A new anti-monopoly law has recently been approved by the Parliament and the Anti Money Laundering legislation is expected to be approved. At the same time, some initial progress in improving anti-corruption legislation is taking place as the government has recently submitted to the parliament the draft law on the Code of Conduct of Civil Servants and on Preventing the Conflict of Interest of Public Officials.

The Government is making efforts to support the development of entrepreneurship in the country. Namely, it has approved the State Program on Development of Entrepreneurship for 2007 -2012 on 30 April 2007, with the purpose to achieve sustainable development of entrepreneurship (especially SMEs) by improving the regulatory framework, fostering better business environment and strengthening the human potential. This ambitious Program consists of 6 main components (i) *improvement of legal and regulatory framework* (adoption of new laws, simplified system for company registration, shorter list of activities requiring licensing and more transparency in licensing process, harmonization of tax system and straightforward property registration system, strengthened competition and improved anti-monopoly regulation); (ii) *better economic infrastructure* (establishment of economic zones, improvement of the IT sector and overall infrastructure in the country); (iii) *provision of informational and advisory services and workforce training* (strengthening of cooperation between universities, enterprises and state bodies with the aim to increase the skills of local workforce; conducting of business forums, exhibitions and setting up a business database); (iv) *provision of financial support* (additional funding to the local enterprise sector to be channeled through the National Fund for the Support of Entrepreneurship, stimulation of commercial lending, leasing operations and improvement of capital markets); (v) *protection of entrepreneurs' rights* (regular monitoring of business environment and trainings for entrepreneurs on legal and judicial systems); and (vi) *promotion of entrepreneurial activity* (use of promotional activities through the local media, stimulation of foreign trade and harmonization of local quality standards with the widely used international standards).

The Government has also taken some initial steps towards improving the regulatory framework in the infrastructure sector. In December 2005 a Presidential Decree established the Tariff Council as a separate budgetary agency responsible for the regulation of prices and tariffs of about 39 goods and services currently regulated by the state, including those for gas, electricity and oil products. This is considered an intermediary step before establishing regulatory bodies in different sectors. One of the first acts of the Tariff Council was to double the retail prices of diesel, kerosene and domestic boiler fuel in January 2006, continuing the Government's policy of raising domestic energy prices to bring them closer to world market levels. In January 2007, the Tariff Council sharply increased the domestic prices for oil products, electricity, water and natural gas for industrial use. Electricity charges increased more than threefold, water prices increased 1.8 times and gas prices for industrial use doubled. The increase in energy prices is expected to reduce waste and improve energy efficiency in the economy.

### **2.2.2 Transition Challenges**

The key transition challenges faced by Azerbaijan are as follows:

- improving the business environment through sustained anti-corruption measures, strengthening administrative capacity, enhancing the regulatory environment and the rule of law, in order to create a level playing field conducive to further development of local private enterprises and attraction of foreign investment.
- developing the non-oil and gas sectors of the economy to ensure poverty alleviation and sustainable development throughout the country including rural areas and cities outside the capital through long-term economic policies and incentive schemes.

- further reforming and strengthening of the financial sector as an effective tool for channelling oil revenues into non-oil sectors and diversification of the economy for sustainable future growth.
- restructuring of the public infrastructure sector and continued investments to improve efficiency and service standards in transport, telecommunications, electricity, gas, water, sewerage, waste treatment, as well as cleaning the heavily polluted environment.
- efficient management of oil and gas revenues and ensuring macroeconomic stability through prudent monetary and fiscal expenditure policy to avoid excessive inflationary pressure and real exchange appreciation.

The specific challenges facing the sectors which the Bank actively operates are as follows:

- **Enterprise Sector:**

The difficult business environment still constrains the development and growth of private enterprises, particularly those operating in the non-oil sector. In particular, the complex tax and customs system, bureaucratic delays and the high level of corruption continue to be major obstacles to private enterprise. The presence of monopolies and strong vested interests in various sectors creates barriers to entry and obstructs the creation of a level playing field. Less government intervention with investments in the non-oil sector is required to improve investors' confidence.

**Agriculture:** Azerbaijan has abundant fertile land and suitable climatic zones for agricultural production and as a result used to export a wide range of high quality agricultural produce within the Soviet Union. Following independence, however, both in absolute terms and relative to GDP, agriculture's role in the overall economy is in decline from 30 per cent in 1989 to 7.5 per cent in 2006. Despite this decline, agriculture is still vital for most households living under difficult conditions in rural areas. Azerbaijan remains an important exporter of fresh fruits, juices and concentrates, and vegetables to Russia and other CIS countries. Nevertheless, agriculture production grew by only one per cent in 2006, suffering from labour migration due to increased employment opportunities especially in the construction sector, while the real exchange rate appreciation has affected its competitiveness. Processing of agricultural products, on the other hand, has gathered pace over the past two years, although further growth of the sector is dependent on improvements to primary production and development of the full supply chain including logistics and retail.

**General Industry:** Following the break up of the Soviet Union, the majority of the industrial and manufacturing enterprises in Azerbaijan went into a sharp decline due to political turmoil, break up of traditional supply and sales links, and a weak local banking system. As a result of failed privatisation attempts and chronic underinvestment, most of the equipment in these enterprises remained worn out and technologically obsolete. With the increase of large scale foreign investment in developing oil and gas sectors and its spill-over effects, various industrial sectors started developing at a faster pace in the past few years, such as construction and production of construction materials, chemicals, furniture etc.. Despite the slowing pace of oil and gas related investments, the construction sector continues to grow rapidly and currently leads growth in the non-oil sector. Increasing inflation coupled with appreciation of the local currency, on the other hand, pose significant risks to domestic enterprises and adversely affect the competitiveness of their products.

**Retail Trade and Property:** As a result of spill over from oil and gas investments and revenues, the average purchasing power, especially in Baku, has increased substantially in the past few years. This has led to a consumer boom which in turn created a fast growing retail trade business mostly concentrated in Baku. The expansion of trade has occurred in parallel with increased property development as the demand for commercial real estate, retail infrastructure, and warehouses has risen. There have also been a number of investments in hotels and tourism, although the majority of property developments occur in the housing sector of Baku, driven by high demand both from local residents and Azerbaijanis living abroad. Nevertheless, both retail and property sectors are subject to high levels of systemic corruption especially stemming from customs and licensing procedures, resulting in low levels of financial transparency across the non-oil economy.

▪ **Financial Institutions:**

**Banking:** Currently there are 44 banks in Azerbaijan which can be divided into three groups: (i) two state-owned banks (IBA and Kapital Bank) controlling roughly half of total bank assets; (ii) around 10 relatively larger commercial banks with close to 30 per cent of assets; and (iii) more than 30 small banks comprising 20 per cent of the sector. Despite being vulnerable to risks and fragmented, the banking sector is growing at a rapid pace, more than 60 per cent in 2006, drawing increased interest from foreign investors. Nevertheless, the sector continues to be dominated by state-owned banks, in particular IBA which limits effective competition. Although there are signs that the Government is considering restructuring and privatisations, as in the case of Kapital Bank, there is not yet a clear strategy towards a substantial reduction of state ownership in the sector. Consolidation among the private banks has so far been slow mainly due to unwillingness of dominant shareholders to be diluted and their ability to support organic growth so far, although this is expected to change during the new strategy period as the banks become larger. The National Bank of Azerbaijan (NBA) has developed key legislation in the past few years improving the legal and regulatory framework in the sector, and strengthened its capacity as the regulator of the financial industry. The regulatory framework in Azerbaijan has been brought closer to international standards, and the enforcement of laws and regulations is continuing to be strengthened. Increasing inflation during the last two years resulted in greater exposure of local banks to foreign exchange and interest rate risks. In addition, given the limited risk management capability of banks and shortage of qualified staff, the recent high growth in bank lending raises concerns regarding the capacity of some banks to respond to negative market shocks.

**MSME:** Development of micro-finance is a key component in promoting the non-oil sector in Azerbaijan. Key challenges in the MSME sector will be to (i) involve more banks in the programme; (ii) build-up a portfolio of critical mass and quality necessary to demonstrate attractiveness of MSME financing and to stimulate local banks to develop MSME financing beyond the EBRD programme; (iii) train local lending specialists; and (iv) reach more MSMEs in the rural areas, where banking services are very limited.

**Non-bank Financial Sector:** The non-bank financial sector remains largely underdeveloped in Azerbaijan. Although there are a number of established insurance companies they are still small and lacking capital and skills to deal with larger risks. The leasing market has only started operating recently and many non-bank financial products are still largely unavailable for companies. Nevertheless, demand for such services and products is strong. Development of capital markets, collective savings and investments, pension funds, leasing and other areas require significant transfer of knowledge and legislative development.

▪ **Infrastructure:**

Azerbaijan's infrastructure sector suffers from chronic underinvestment in the past, deferred maintenance and a weak regulatory environment. The current level of basic infrastructure hinders economic recovery, jeopardises the country's competitiveness and reduces the likelihood of attracting quality foreign investors. Although the overall condition of transport, telecoms and municipal infrastructure is inadequate throughout Azerbaijan, the situation is particularly poor in rural areas.

**Transport:** The Government of Azerbaijan continues to give priority to the rehabilitation and upgrading of its principal corridors, in order to facilitate trade and regional co-operation with its neighbours and facilitate economic development across the country as a whole. Azerbaijan has also played an active part in the work of the High Level Group on the extension of major trans-European transport corridors to neighbouring countries and regions, participates in the Transport Corridor Europe Caucasus Central Asia (TRACECA) programme, and constitutes an important partner in the EU's strategy to strengthen links with Central Asia. About 50 per cent of freight in Azerbaijan is transported by road and the remainder is transported by pipeline and rail in roughly equal proportions. Road is by far the dominant mode of transport for passengers, accounting for about 86 percent of total passengers. The Bank has, to date, invested considerable resources in the transport sector in Azerbaijan, with investments covering road, rail, and air navigation services. The Government has also accelerated its investment programme particularly in the last year, focusing on road transport. Investment needs, however, remain considerable.

**Municipal Infrastructure:** Large investments are required to improve municipal services across the country in all sectors such as water supply, waste water, sewerage, solid waste, and public transport. Sector restructuring, conditionality for an improved regulatory environment, and substantial technical assistance will be essential components for the success of municipal infrastructure projects.

▪ **Energy:**

**Power:** The Azeri power sector has been plagued by low collections, below-cost tariffs, deteriorating infrastructure, and high losses. As a result, Azerenerji, the state-owned electricity utility continues to be heavily subsidised by the Government. The poor condition of the assets is mainly due to the absence of any substantial investment during the 1990s, although investments in the sector have increased since. Low levels of maintenance and lack of technical skills worsened the situation leading to shortages of supply and service quality below acceptable standards for both industrial and residential customers. In the electricity sector, most of the power plants have now reached the end of their useful life time and are largely inefficient, while their sites are contaminated by heavy fuel oil and asbestos, posing environmental challenges. Although a number of projects in electricity generation and transmission have been launched by the Azeri Government, including Azdres TPP financed by the Bank, the level of current investments are not sufficient to cope with increasing demand for reliable power in the country. An attempt to transfer a part of the distribution activities from Azerenerji to the private sector was not successful, and the concession of the private investor has been cancelled, leading to a legal dispute. In order to tackle these difficult issues, the Government has now decided to take bold measures and is considering to launch a detailed structural reform programme. As a first step, following years of below cost tariffs, the Government has committed itself to improving commercialisation in the sector, including adoption of a ‘Medium-Term Tariff Policy’ designed with technical assistance from the international community, aimed at achieving cost-recovery tariffs in the sector, alongside support in managing affordability implications. The Tariff Council has increased electricity tariffs for all users by three-fold in the beginning of 2007, as well as for other key utilities (water, sewerage and solid waste collection), with a view to reduce Government subsidies, create an incentive for energy efficiency, and attract private sector participation in power generation and distribution. The Bank has initiated detailed policy dialogue with the Government in order to help design and undertake a more extensive restructuring of the power sector. Given the Bank’s track record in restructuring and privatisation of the energy sector in other transition economies, the Government has requested the Bank’s involvement in establishing a legal and regulatory framework suitable for independent power producers. Nevertheless, detailed sector restructuring plans remain to be prepared and implemented both for the power and downstream gas sectors.

**Natural Resources:** The ACG and Shah Deniz upstream development and the respective oil and gas export pipelines of BTC and SCP have been a major success. Oil revenues from ACG continue to provide security to finance shorter term financings for the Shah Deniz and SCP projects. There is, however, a considerable amount of investment required domestically with regard to rehabilitation of the gas storage capacities, trunk pipelines and the gas distribution network. Although Azerbaijan is now able to attract competitive financing from commercial markets with the security of oil revenues, the longer term financing required for rehabilitating, upgrading and replacing existing domestic infrastructure still remains a challenge. Currently, domestic gas activities are the responsibility of the state owned gas utility, Azerigaz. Given its capacity to raise finance, SOCAR is expected to take responsibility for some of these assets, such as gas storage. Any significant investment in domestic gas infrastructure will require clarity on the future structure of the sector. On the other hand, Azerbaijan is considering major foreign investments in the oil sector, such as transport and refining, with a view to utilise its supplier position and growing expertise. Within this context, Azerbaijan is making efforts to become an energy transit country in the medium term, in addition to being a supplier only, given its limited reserves of hydrocarbons. The transformation of Azerbaijan into a transit country between Central Asia and Europe is important for its future sustainable development and fully supported by the EU in the context of the “Baku Initiative”, a policy dialogue aimed at enhancing cooperation in both energy and transport fields between EU and the countries of the Black Sea, the Caspian Basin, and their neighbours.

### **2.2.3 Access to Capital and Investment Requirements**

Azerbaijan has substantial investment and rehabilitation needs in both public and private sectors as a result of many years of underinvestment due to lack of adequate funds. On the other hand, following the successful development of the oil and gas sectors and high oil prices in the past few years, Azerbaijan's financial resources as well as its borrowing capacity have increased significantly.

The Government plans to continue investing in social and infrastructure projects from its own budgetary sources, and has embarked on a number of large infrastructure projects without funding from IFIs. The added value of IFI co-financing, however, is recognised in terms of specific technical assistance, implementation capacity building, and advice on sector reforms. The scale of the planned infrastructure investments is another factor in Government's strategy to continue its sovereign borrowing from multilateral sources in the medium term.

Azerbaijan currently has no IMF programme. The latest three-year programme was concluded in mid-2005. The IMF is currently discussing an advisory role with the Government. The World Bank has approved its new Country Partnership Strategy for 2007-2010, which envisages a lending programme of up to \$250 million per year. While around 80 per cent of this amount is planned to be provided for infrastructure projects (roads, railways, water, energy, and utilities), the rest is earmarked for reforming accountancy, judiciary, education, health and other social services. Similarly, the Asian Development Bank, the Islamic Development Bank, and various other multilateral and bilateral institutions have offered funding to the Azeri Government for its planned investments in the medium term.

In addition to multilateral funding institutions, an increasing number of foreign commercial banks are prepared to provide large financial resources to projects with sovereign guarantees or other state undertakings. The Government also plans to tap into foreign capital markets through a Eurobond issue in 2007, as the country's sovereign risk rating has improved recently (Moody's: Ba1; Fitch: BB+). The bond issue is expected to create a benchmark for country risk spread and to pave the way for local corporates and banks to have increased access to international financial markets. The state-owned IBA has already managed to receive a \$130 million syndicated loan at 90bp without a sovereign guarantee at the end of 2006, and plans to issue a \$200 million Eurobond issue by the end of 2007. Local commercial banks have considerably increased their lending activities since the last strategy period, but access to financing is still limited. On average, loans have short maturities (around 1 year), while the interest rates are high (18-24 per cent per annum in USD). As local commercial banks are unsophisticated and less developed by international standards, this raises concerns about the ability of some banks to cope with possible external shocks.

Despite significant foreign investment in the oil and gas sectors, estimated at close \$30 billion to date, FDI in the non-oil sector still remains marginal due to the difficult business environment. Remittances from Azerbaijanis working abroad, on the other hand, are estimated at about \$1.5 billion for 2006, and are expected to continue to play a key role in economic development.

## **3. STRATEGIC ORIENTATIONS**

### **3.1 The Bank's Priorities for the Strategy Period**

In response to the transition challenges identified in Azerbaijan, the Bank's approach during the next strategy will be to support economic diversification and help create conditions conducive to long-term sustainable development and poverty alleviation. The Bank's priorities will be:

- engaging actively in further sector reforms working with both public and private sectors, and continuing policy dialogue with the authorities to improve the investment climate.
- supporting the corporate sector, working with both local entrepreneurs and foreign investors, with

a focus on diversification of the economy into the non-oil and gas sectors including rural development and improvement of industry standards to an international level.

- continuing its leading role in developing the banking sector, enhancing further competition, stimulating access to financial services in rural areas, and developing non-bank financial services.
- increasing its role in financing key infrastructure projects focusing on transport, energy, and environmental clean-up, supporting capacity building and encouraging private sector participation through sector restructuring and supporting potential Public-Private Partnerships.

## **3.2 Sectoral Challenges and Bank Objectives**

### **3.2.1 Enterprise Sector**

Successful development of the enterprise sector will depend on the creation of a conducive legal, tax, customs and financial reporting system. The Bank will continue its efforts for the diversification of economy into non-oil sectors, and support regional development. The Bank will work directly and indirectly to support private sector enterprise and further expand its micro business and SME financing. While supporting local investments, the Bank will seek to improve standards of management, accounting and marketing, enhance financial transparency and corporate governance. The ETCI products will be essential in reaching out to medium-sized local companies which are the key drivers of the non-oil GDP and employ the majority of the population. The Bank will strive to expand the reach of its ETCI products to regions outside the capital especially in the agribusiness sector. The Bank will continue close cooperation with local banks and utilise their understanding and knowledge of local clients, especially through co-financing under the MCFF. The ETCF is an important element in supporting the Bank's activities in the local enterprise sector. The demand for technical assistance funding from ETCF will continue for specific due diligence assignments, building capacity within partner banks and supporting the TAM/BAS activities in Azerbaijan. In addition the Bank will seek to introduce mechanisms and products for encouraging energy efficiency improvements throughout the enterprise sector. The Bank will also seek to facilitate foreign investments in the non-oil sectors of Azerbaijan with transfer of know-how and technology. The Bank's investments will be supplemented by an active policy dialogue for improvements in the business environment. More specifically, the Bank will:

- pursue investment opportunities in all enterprise sectors. The Bank will maintain its focus on ETCI products such as MCFF, DLF and DIF to reach out to medium sized local entrepreneurs. Integrity due diligence and readiness of sponsors for greater financial transparency will continue to be key factors in project selection.
- increase its focus on the agribusiness sector in line with the Government's priorities. To this end, the Bank will seek opportunities in the areas of food and beverages processing and packaging with commercial entities which have developed the necessary logistic, sales and distribution infrastructure. The areas of fruits and vegetables processing, dairy, confectionery, water, juice and soft drinks production, retail and wholesale distribution will be given particular attention.
- in view of the importance of primary production, seek to indirectly support farmers by promoting expansion of commercial banks' regional networks, including support for financial institutions with a particular focus on rural development and assisting micro-finance institutions working in rural areas.
- support both large and small projects in the building materials sector, as it is anticipated that the construction sector in Azerbaijan will continue to show strong growth, generating demand for basic construction materials such as cement, concrete, pipes, tubing and tiles. Furniture production and other products related to home improvements will also be considered.
- consider financing commercial office development, housing, health, tourism, logistics and retail projects in the property sector.
- consider co-operating with state agencies created to channel oil wealth to the non-oil

enterprise sector and to attract foreign investment, such as the newly established AIC. Through joint investments with these agencies, the Bank will help ensure that state funds are distributed in a transparent manner and corporate governance standards are enhanced.

- continue to provide assistance to SMEs through the Turnaround Management (TAM) and Business Advisory Services (BAS) Programmes with a focus on improving management skills, market positioning, information systems, quality certifications, technical and environmental upgrades.

### **3.2.2 Financial Institutions**

The Bank's transition objectives in the financial sector will be to actively promote consolidation in the sector by encouraging mergers among private banks, support institutional strengthening and gaining critical mass by local banks, enhance competition through financial support, encourage international standards of corporate governance, increase transparency especially with respect to banking relationships between related parties, continue to strengthen supervisory capacity and support the banks and other financial institutions to increase the quality of their management and staff. The Bank will also assist the sector in improving access to both debt and equity finance. The Bank's operational objectives will be to:

- continue supporting the best performing local commercial banks in the form of senior, subordinated and syndicated debt products, and continue providing SME and MSME credit lines.
- actively participate in and encourage mergers and acquisitions as well as support institutional strengthening of local banks with the objective of developing strong and competitive market players capable of providing a wide range of banking products and services required by real sector borrowers. The Bank will continue to seek opportunities in acquiring equity stakes in dynamic and well-managed banks.
- improve capacity and implement sound banking and good corporate governance practices in partner banks through tailored technical assistance.
- provide targeted technical assistance and transfer of know-how under MCFF, in order to better serve medium-sized private entrepreneurs while building sound lending capacity within banks.
- should they proceed, monitor IBA, Kapital Bank and other privatisation efforts, and to the extent possible, facilitate the process.
- increase support to existing and new micro-finance institutions by providing credit lines and technical assistance.
- continue to implement projects in the non-bank financial sector (insurance and leasing). Seek to identify reliable and committed sponsors and consider debt and equity support as well as technical assistance to help further develop the sector.

### **3.2.3 Infrastructure and Energy**

Notwithstanding the cheaper and more flexible sources of finance now available to Azerbaijan, the Bank, at the request of the Government, is expected to play an important and bigger role in the large infrastructure and energy investments planned for the medium term, following on from its early investments in power, transport and municipal infrastructure sectors. The key factor for the Bank's involvement will be its additionality in terms of transparent procurement practices, specific technical assistance, implementation capacity building, commercialisation of state-owned enterprises, advice on sector reforms, and experience in the introduction of the private sector. This has been demonstrated by the Government's milestone decision to finance the Azdres thermal power plant rehabilitation through an EBRD loan at the end of 2006, under which specific technical assistance has been mobilised both for project implementation and institution building within the sector.

**Transport:** The Bank's focus will continue to be on the main transport arteries in Azerbaijan, but

where required, projects could also focus on the wider transport network with the aim of ensuring development of transport infrastructure in the regions. Close co-ordination and co-operation with other IFIs now working in Azerbaijan will also be a key theme of the Bank's activity, particularly given the recent agreement to cooperate with the European Investment Bank (EIB) in the region and provide co-financing. The transition objectives underpinning the Bank's involvement in Azerbaijan's transport sector are as follows: (i) maximising the potential of the east-west transit corridor; (ii) commercialisation of the sector, through measures aimed at improving efficiency, and institutional reform; (iii) seeking opportunities for private sector engagement, where practical; and (iv) supporting the development of the regions. In terms of operational priorities, the Bank will:

#### *Roads*

- focus on upgrading of the east-west road link where economically viable, working on a parallel basis with the EIB and other IFIs.
- consider possible financing of a road works programme in a number of municipalities, given that the newly established roads authority (Azeryolservice) has also been assigned responsibility for roads within cities. Within this project, provide technical support to ensure that Azeryolservice has the institutional capacity to effectively manage this newly acquired task.
- ensure successful implementation of the two road projects presently under construction, Hajigabul to Kurdamir located on the east-west transit corridor, and Baku to Samur located on the north-south corridor. The implementation of measures aimed at improving the efficiency of Azeryolservice and its maintenance units will also be a priority.

#### *Railways*

- in the short-term, provide a loan for the immediate needs in the railway sector with a focus on locomotives, which will also be linked to measures aimed at commercialising Azerbaijan State Railways.
- in the medium term, consider financing for a broader based project which will fund both rolling stock and track improvements throughout the network. Given the scale of this project, other IFIs are expected to be involved through parallel financing arrangements.

#### *Ports, Shipping, Aviation*

- in the port sector, continue focus on the east-west link and more specifically Baku Port. A study will be considered to assess the feasibility of a possible relocation of the port to a location outside central Baku.
- in the shipping sector, give consideration to providing assistance to the shipping companies as and when required.
- in the aviation sector, consider financing for the improvement of air transport infrastructure and support for the modernisation of the sector with a view to improve the safety standard of operations, through investments in airport infrastructure, air traffic management, and assistance to strengthening of civil aviation administration. The Bank will also consider aircraft financing, in particular cargo, on an asset backed basis, as Azerbaijan is in the process of ratifying the aircraft protocol of the Cape Town Convention, which will facilitate such financing.

**Municipal Infrastructure:** While a number of IFIs and bilateral donors are focusing on the water and waste water sectors, the Bank will continue discussions on the development of solid waste management projects. Any new operation in the municipal sector will require a strong commitment by the counterparts to commercialisation, cost recovery and structural reforms, taking into account lessons learned from previous projects. In addition to Baku, the Bank will consider financing smaller projects in secondary cities to establish a demonstration effect.

**Power:** The Bank's focus during the strategy period will be on effective implementation of existing projects in the electricity sector, further rehabilitation of infrastructure, as well as consideration for new electricity generation and transmission projects. The Bank will deepen its policy dialogue, and

take a lead role in providing technical assistance for sector restructuring, promotion of private investment, institutional capacity building, and project preparation. Coordination with other IFIs and donors, especially EC within the context of the MoU for a partnership in the energy sector, will be a key element of the Bank's involvement in the sector in order to ensure complimentary support and prioritisation of investments. The Bank will, in particular, seek to utilise the ENPI National Indicative Programme funds for energy sector restructuring with the approval of the Government. The Bank's specific priorities will be to:

- ensure timely and effective implementation of Azdres Thermal Power Project which is expected to take about two years and will result in the rehabilitation of the largest power plant that produces half of the country's electricity.
- promote the utilisation of the Clean Development Mechanism (CDM) established under the Kyoto Protocol, through instruments including the Bank's Multilateral Carbon Credit Fund, for eligible carbon emission reduction projects such as the rehabilitation of the Azdres thermal power plant.
- provide substantial technical assistance for power sector restructuring, improvement of the legal and regulatory framework, and preparation of an action plan for the introduction of private investors (including independent power producers) to increase competition and reliable supply.
- consider providing financing for new power generation and power distribution projects.
- provide technical assistance to the Tariff Council for the definition and evaluation of tariffs and assist in institutional capacity building.
- consider the establishment of a framework under which environmental clean-up (including regeneration of old power plant sites), energy efficiency, and renewable energy projects can be identified, appraised, and financed.

**Natural Resources:** Despite the Bank's current focus on non-oil and gas sectors, there are a number of areas in the natural resources sector which may require the Bank's expertise and financing within the context of Azerbaijan's efforts to become an energy transit country and clean up its polluted environment. In particular, during the next strategy period the Bank will consider:

- financing the rehabilitation of the Kalmaz and Karadag gas storages in line with increasing gas production and demand for seasonal storage.
- participation in the rehabilitation and capacity increase of the Azerbaijan-Georgia gas pipeline, in coordination with the EC and EIB, as well as other energy transport initiatives.
- smaller oil and gas upstream projects which would have a high transition impact potential.
- financing environmental clean-up, land remediation and reclamation projects.

### **3.2.4 Policy Dialogue and Investment Climate**

In close cooperation with other IFIs and bilateral donors, the Bank will continue its policy dialogue with national authorities, local business community, and foreign investors on actions needed to improve the investment climate, including legislative and regulatory reform as well as institutional strengthening. The Bank's efforts will specifically focus on the following:

- continued dialogue with the authorities regarding measures to strengthen the financial sector and enhance competition through improved legislation.
- support for specific measures which the authorities plan to undertake in order to improve the business environment in the non-oil sector.
- improved corporate governance and institution building at AIC through active co-operation and parallel investments.

- dialogue with the authorities over power sector reform and introduction of private sector in electricity generation.
- technical support for institution building at the Tariff Council, and establishment of improved tariff policies.

The Bank will continue and enhance its policy dialogue with the authorities in coordination with the local and foreign business community, other IFIs and donors. Through this dialogue, the Bank will aim to assist improving the business environment, laying the foundations for long-term economic diversification, channelling growth into rural areas and secondary cities, strengthening the banking sector, and fostering regulatory reforms. In this respect, the Bank will continue to provide stand-alone technical assistance for legal transition assignments and capacity building for various state agencies.

#### **4. CO-OPERATION WITH IFIs AND DONORS**

There are many active IFIs and bilateral donors in Azerbaijan, ranging from the traditional sources of support in the region such as the World Bank Group, USAID, KfW and Japanese ODA to the increasingly active ADB and Islamic Development Bank, as well as new entrants such as Chinese, Korean and Middle Eastern financing institutions. In addition to the large number of active financiers, the willingness to lend has also increased in the past two years due to Azerbaijan's increasing creditworthiness based on oil revenues.

Cooperation among the IFIs and donors take place through consultations on an individual project level or in some cases on a sectoral basis, although improved coordination may be required given the increasing number of large-scale projects in transport, energy, and municipal infrastructure sectors with the participation of various financiers, including commercial banks.

The Bank is in close contact with the key active IFIs and donors in the country and endeavours to coordinate both its financing and technical assistance activities, in order to ensure complementary assistance rather than duplication of efforts. In particular, a new formal collaboration is being put in place with EIB, which is preparing to commence its activities in Azerbaijan. See Annex 7 for a detailed list of technical cooperation projects funded by the Bank and donors. Further information on the activities of key IFIs and donors is provided in Annex 8.

## **ANNEX 1: POLITICAL ASSESSMENT**

### **Political Assessment**

Azerbaijan is committed to and is making progress towards implementation of the principles of Article 1 of the Agreement Establishing the Bank. The economic progress is demonstrable and widely recognised, while progress in transition towards multi-party democracy and pluralism has been slow, with many challenges remaining.

The authorities are co-operating with the Venice Commission of the Council of Europe on the revision of the Election Code and the Law on Freedom of Assembly. This is especially relevant in the light of the forthcoming presidential election in 2008. The latter presents an important opportunity for making progress towards free and fair elections and freedom of the media.

Membership of the Council of Europe since January 2001, and the November 2006 Action Plan, adopted with the EU in the framework of the European Neighbourhood Policy (ENP), are providing strong incentives for bringing the country's laws in line with European standards and for demonstrating commitment to Europe's democratic values.

In its latest monitoring report the Parliamentary Assembly of the Council of Europe recognised the efforts made by Azerbaijan in a number of areas, including cooperation with the Venice Commission; the establishment of the Justice Academy; training and recruitment of new judges; an improvement in local self-government; progress on the issue of political prisoners; the new National Action Plan for Protection of Human Rights, and the constructive attitude of the President of Azerbaijan towards a search for a solution to the Nagorno-Karabakh conflict.

At the same time, the monitoring report highlighted the remaining areas of concern including deterioration in the media situation, lack of checks and balances between various branches of power and insufficient implementation of a number of Council of Europe commitments.

The major conflict of Nagorno-Karabakh, which has a direct bearing on the social, political and economic situation in the country and the region, remains unresolved, although the parties came closer to finding a mutually acceptable solution. 20 per cent of Azerbaijani territory is still occupied by Armenian forces, affecting the lives of nearly one million refugees and internally displaced persons.

### **Political Environment**

The Constitution provides for a strong presidential system. Ilham Aliyev succeeded his father Heydar Aliyev after the presidential election of 15 October 2003, which, according to OSCE/ODIHR, did not fully correspond to international standards. Since his election, President Aliyev has been successfully consolidating his power. In the aftermath of the elections, opposition has further weakened. Divided, and unable to reconcile personal ambitions of their leaders, the opposition is failing to broaden their popular appeal and remains marginalised. Weak opposition presents little challenge to the Azerbaijani President who is expected to win another five-year term in office in the 2008 presidential election.

The legislative power is vested in the Milli Mejlis (the Parliament), a unicameral body composed of 125 MPs and elected for five years. The last parliamentary elections took place on 6 November 2005. There was a re-run on 13 May in 10 constituencies, in which the results of the November elections were cancelled by the Central Electoral Commission (CEC) and the Constitutional Court. The constitutional amendments of 2002 eliminated the proportional list component of parliamentary elections and all 125 seats were elected in single seat constituencies. 48 political parties and electoral blocs were registered for the 6 November election.

As a result of the elections, the New Azerbaijan Party (YAP), chaired by President Ilham Aliyev, maintained its dominant position in Parliament. Despite calls to the contrary, most members of the opposition Azadliq group elected in November refused to take their seats in Parliament and boycotted the partial parliamentary re-run in May. The MPs from the Musavat party, which also belonged to the Azadliq group, decided to take up their seats, effectively splitting the main opposition bloc. There is little contact between the ruling party and the opposition. The Council of Europe and the OSCE called for a constructive dialogue between the two, underscoring the country's commitment to political pluralism.

Notwithstanding improvements during the pre-election period, such as inclusive candidate registration which provided for a competitive election in most constituencies and enhanced voter choice, the November 2005 parliamentary elections did not meet a number of OSCE commitments and other international standards.

Following the elections, the OSCE/ODIHR formulated a list of recommendations for improving the electoral process in the country, including a reconfiguration of the composition of electoral commissions and other amendments to the election-related legislation. Parliament has yet to play a role in balancing the strong executive branch of power, although it has strengthened over the years as an important forum for political debate and enacting laws.

The major conflict with Armenia over Nagorno-Karabakh remains unresolved. Upon their accession to the Council of Europe in January 2001 Armenia and Azerbaijan committed themselves to use peaceful means for settling the conflict. The conflict can be resolved on the basis of respect of the principles of sovereignty, territorial integrity and inviolability of internationally recognised borders of states. The Minsk Group of the OSCE, co-chaired by the United States, France and Russia, continues to be the mediator of the conflict, although the issue is also discussed in wider international forums. The question of protracted conflicts in the GUAM (Georgia, Ukraine, Azerbaijan, Moldova) area and their implications for international peace, security and development, has been included in the agenda of the 62nd session of the General Assembly of the United Nations due to take place in September 2007.

### **Human Rights Conditions and Freedom of Media**

The Constitution and the laws provide a legal framework for the protection of human rights and fundamental freedoms. Azerbaijan is also party to most UN treaties on human rights and ratified the Council of Europe international conventions, including the Convention for the Protection of Human Rights and Fundamental Freedoms.

According to human rights monitors, the Government record in this area is poor with many problems being reported, especially with regard to the freedom of expression. There are many media outlets in Azerbaijan, including print media, radio and TV stations. Television is the main source of information for most of the population. Following the recommendations from the Council of Europe and the OSCE Representative of the Freedom of Media a public service broadcaster (Public TV or ITV) was established in 2005.

Since Azerbaijan gained independence, its media has been transformed from a state-run system into a variety of new, including private, media outlets. The Government abolished censorship, adopted mass media laws and liberalised registration procedures. However, media continues to face difficulties such as the increased violation of journalists' rights. A serious obstacle is criminal libel and insult legislation. Journalists receive prison sentences which have a chilling effect on the media's independence. The OSCE Representative on Freedom of Media, supported by the OSCE Chairman-in-Office, the EU and the United States, urged the Government to end the use of criminal defamation to limit media freedom. Decriminalisation of libel is aimed at protecting freedom of expression for members of the media and is a vital component of democratic governance. The EU referred to the commitments made in the framework of the OSCE and the Council of Europe, as well as in the context of the ENP, and appealed to the Government to improve the situation.

Corruption remains pervasive. The authorities of Azerbaijan consider corruption a serious problem, which could jeopardise the vast economic growth the country has experienced in recent years. In Transparency International's Corruption Perception Index (CPI) 2006, Azerbaijan ranked 130 (out of 163 countries) with a score 2.4 out of 10 (compared to 2.2 out of 10 in the 2005 Index), improving its ranking in comparison to four countries of Central Asia (all with the exception of Kazakhstan) and Belarus. In a resource-rich country such as Azerbaijan, revenue reporting is vital in combating corruption. In this respect, the country took a positive step by implementing the recommendations of the UK Government's Extractive Industries Initiative (EITI). Greater transparency and accountability in the resource sector is crucial for eradicating corruption.

The Government has ratified the core ILO Conventions, including the Convention 182 on the elimination of the worst forms of child labour. The Constitution and the laws of the country prohibit forced or compulsory labour, although there were reports of incidents of forced labour, including cases of trafficking in persons. The law provides for the protection of children from exploitation in the workplace and from work that is dangerous to their health, but there were few complaints of abuses of child labour laws.

The US State Department's Trafficking in Persons Report of June 2007 designated Azerbaijan as a Tier 2 country, which means that the Government of Azerbaijan does not fully comply with the minimum standards for the elimination of trafficking; however, it is making significant efforts to do so. Azerbaijan is primarily a source and transit country for trafficking purposes. In 2005, the Government of Azerbaijan adopted a Law on the Fight Against Trafficking in Persons and corresponding amendments to the criminal code, envisaging criminal liability for forced labour and sexual exploitation. In 2006, the Government opened a shelter for trafficking victims and increased training for law enforcement officials. Further tangible steps are required in order to improve the situation.

### **External relations**

Azerbaijan has an important geo-strategic location, linking the resource-rich Central Asia and Caspian Sea basin with Europe. Bordering Russia, Iran, Georgia, Armenia and Turkey, the country is bound to consider many geopolitical interests. Azerbaijan remains neutral in the stand-off between the United States and Iran. Any risk of instability in neighbouring Iran will have direct implications for the country because of a large number of ethnic Azeris in the north of Iran.

Azerbaijan maintains traditionally good relations with Georgia and Turkey, the countries providing a major transit route for its oil and gas to world markets along the East-West corridor. A member of the CIS, Azerbaijan is balancing its foreign policy orientations and striving to maintain good relations with its immediate neighbours as well as the US and the EU.

The June 2007 Baku Summit of the GUAM, comprising Georgia, Ukraine, Azerbaijan and Moldova, gave a new impetus to the organisation, whose members are united in their willingness to be integrated into Euro-Atlantic organisations. The Summit underscored the GUAM's transit potential and its strategic role in linking Europe and Asia. The rotating chairmanship in the organisation was passed to Azerbaijan.

With a strategic location and huge energy reserves, Azerbaijan's economy grows rapidly and is poised to continue unprecedented growth in the future. The country is keen to diversify its economy and avoid reliance on oil and gas revenues. An important step in integrating Azerbaijan into the world economy will be accession to the WTO, which will signal the country's desire to meet a set of international standards.

The ongoing talks on the legal status of the Caspian Sea have not yet produced a final settlement involving agreement of all five littoral states, although a lot of progress has been achieved, including environmental aspects. A Summit of the Heads of States is expected to give an impetus to the process.

## ANNEX 2: SELECTED ECONOMIC INDICATORS

	2001	2002	2003	2004	2005	2006	2007
						<i>Estimate</i>	<i>Projection</i>
<b>Output and expenditure</b>	<i>(Percentage change in real terms)</i>						
GDP	9.9	10.6	11.2	10.2	26.4	34.5	30.0
Private consumption	9.9	13.1	6.0	6.9	21.7	na	na
Public consumption	4.9	0.5	11.1	4.6	19.7	na	na
Gross fixed capital formation	20.6	64.8	72.6	13.0	14.6	na	na
Exports of goods and services	34.1	14.0	9.2	-9.0	70.9	na	na
Imports of goods and services	33.0	48.4	45.6	-9.5	21.9	na	na
Industrial gross output	5.1	3.6	6.1	5.7	33.5	36.6	na
Agricultural gross output	11.1	6.4	5.6	4.6	7.5	0.9	na
<b>Employment</b>	<i>(Percentage change)</i>						
Labour force (end-year)	0.4	0.4	0.6	1.7	1.1	3.1	na
Employment (end-year)	0.3	0.3	0.6	1.7	1.1	3.2	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	1.3	1.4	1.4	1.4	1.4	1.3	na
<b>Prices and wages</b>	<i>(Percentage change)</i>						
Consumer prices (annual average)	1.5	2.8	2.2	6.7	9.6	8.3	16.0
Consumer prices (end-year)	1.5	3.3	3.6	10.4	5.5	11.4	14.0
Producer prices (annual average)	1.8	-2.3	16.1	12.9	10.6	17.7	na
Producer prices (end-year)	-5.2	7.2	11.2	21.9	10.8	17.1	na
Gross average monthly earnings in economy (annual average)	17.3	21.3	21.4	26.2	21.9	19.8	na
<b>Government sector</b>	<i>(In per cent of GDP)</i>						
General government balance <sup>1</sup>	-0.4	-0.5	-0.8	1.0	2.6	0.1	2.4
General government expenditure	18.7	27.7	28.5	25.9	22.7	28.9	na
General government debt	20.9	20.5	20.0	18.6	13.3	na	na
<b>Monetary sector</b>	<i>(Percentage change)</i>						
Broad money (M2, end-year)	7.7	15.6	27.9	31.9	15.8	168.3	na
Domestic credit (end-year)	-38.1	85.9	13.2	60.2	52.9	63.6	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	6.6	6.7	7.3	8.0	6.3	12.0	na
<b>Interest and exchange rates</b>	<i>(In per cent per annum, end-year)</i>						
Refinance rate (6 months)	10.0	7.0	7.0	7.0	9.0	9.5	na
Interbank interest rate (3 months) <sup>2</sup>	19.8	19.7	20.3	16.6	15.3	14.3	na
Deposit rate	8.5	8.7	9.5	9.2	8.5	10.6	na
Lending rate	19.7	17.4	15.5	15.7	17.0	17.7	na
	<i>(Manats per US dollar)</i>						
Exchange rate (end-year) <sup>3</sup>	1.0	1.0	1.0	1.0	0.9	0.9	na
Exchange rate (annual average) <sup>3</sup>	0.9	1.0	1.0	1.0	0.9	0.9	na
<b>External sector</b>	<i>(In millions of US dollars)</i>						
Current account	-49	-770	-2,021	-2,588	167	3,106	5,700
Trade balance	581	482	-98	162	3,299	7,745	na
Merchandise exports	2,046	2,305	2,625	3,743	7,649	13,014	17,420
Merchandise imports	1,465	1,823	2,723	3,581	4,350	5,269	6,057
Foreign direct investment, net	299	1,048	2,353	2,351	458	-926	-4,963
Gross reserves, excluding gold (end-year) <sup>4</sup>	725	721	803	1,075	1,178	2,500	na
External debt stock	1,154	2,603	2,744	3,489	4,345	4,877	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	4.1	2.8	2.0	2.0	2.0	3.8	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	4.9	4.4	5.2	3.6	1.3	1.1	na
<b>Memorandum items</b>	<i>(Denominations as indicated)</i>						
Population (end-year, million)	8.1	8.2	8.3	8.3	8.4	8.4	na
GDP (in billions of manats)	5	6	7	9	13	18	24
GDP per capita (in US dollar)	705	760	881	1,051	1,577	2,363	na
Share of industry in GDP (in per cent)	37.6	37.4	37.2	38.3	47.5	57.5	na
Share of agriculture in GDP (in per cent)	14.7	13.8	12.2	10.8	9.0	6.9	na
Current account/GDP (in per cent)	-0.9	-12.3	-27.8	-29.8	1.3	15.6	na
External debt - reserves (in US\$ million)	429	1,882	1,941	2,414	3,167	2,377	na
External debt/GDP (in per cent)	20.2	41.7	37.7	40.2	32.8	24.6	na
External debt/exports of goods and services (in per cent)	49.4	97.6	89.8	82.4	52.2	35.6	na

Notes: 1 General government consolidates all levels of government, except for municipalities and state-owned enterprises, and includes the State Oil Fund and other extra-budgetary funds. 2 90-day interbank offer rate in manats, nominal. 3 In January 2006 Azerbaijan introduced a new currency denomination. One new manat is equal to 5000 old manat. All data are retrospectively converted in new manat. 4 By end-December 2006 there were additional foreign exchange assets of approximately US\$ 1.4 billion in the State Oil Fund.

### ANNEX 3: LEGAL TRANSITION

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of such laws (also referred to as “effectiveness”). All available results of these assessments can be found at [www.ebrd.com/law](http://www.ebrd.com/law). This annex presents a summary of the results for Azerbaijan, accompanied by critical comments of the Bank’s legal experts who have conducted the assessments.

#### Capital Markets

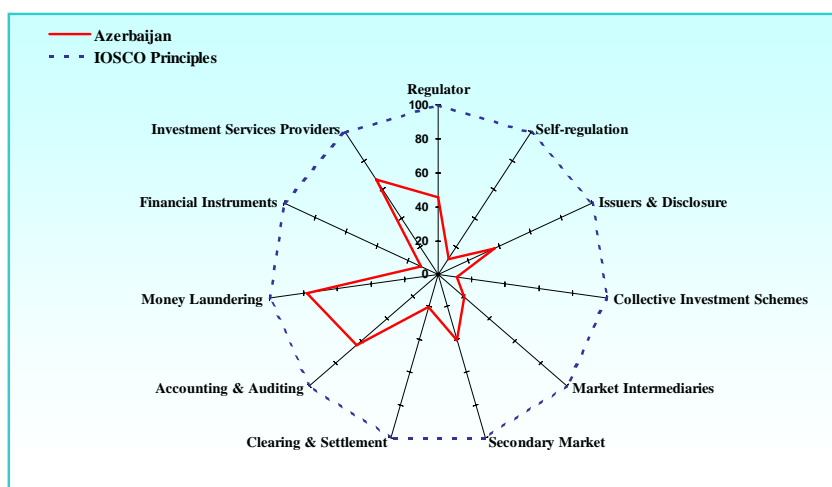
Azerbaijan’s securities markets framework is essentially entrusted in the Civil Code in the “Law on the Protection of Rights of Investors on the Securities Market” and in the “Law on Investment Funds”.

The main institutions in the Azerbaijani securities market are the State Committee for Securities under the Auspices of the President of Azerbaijan (the “SCS”); the Baku Stock Exchange and the National Depository Centre.

In 2005, the EBRD benchmarked the securities markets framework in Azerbaijan against the IOSCO Objectives and Principles of Securities Regulations (see the chart below). The country scored “very low compliance” showing a situation under a critical need for reform in all areas under assessment. A positive note however is the recent adoption of rules adopted by State Securities Committee and methodology and principles adopted by NBA addressing money laundering.

When assessing the framework on the regulator, the assessment evidenced that the SCS has little operational and functional independence. It can issue administrative sanctions but they are generally inadequate to discourage illegal behaviours. Weaknesses were registered also in the area of self regulatory organisation (SRO). The country has adopted a set of rules for SRO, but they are insufficient in many respect. When turning the attention to disclosure rules, it was evidenced that public offering of securities must be accompanied with a prospectus but many of the rules are unclear. Rules on surveillance of the secondary market are weak and no investment protection measures or prudential requirements exist. Finally, shares are not dematerialised, and securities clearance is not centralised. As a consequence, doubts arise on the delivery versus payment system in place.

#### Quality of securities market legislation – Azerbaijan (2005)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO’s *Objectives and Principles for Securities Regulations*. The fuller the ‘web’, the closer the relevant securities market legislation of the country approximates these principles.

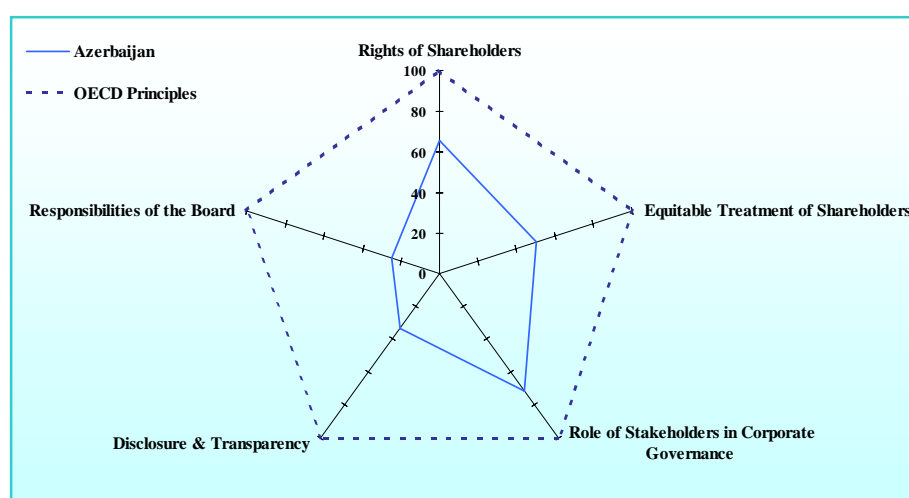
Source: EBRD Securities Market Legislation Assessment 2005

## Company Law and Corporate Governance

The corporate governance framework in Azerbaijan is essentially entrusted in the Civil Code. In 2004 a new “Law on Banks” and a “Regulation of the National Bank of Azerbaijan on Regulation on Implementation of Corporate Governance Standards in Banks” came into force, improving the corporate governance practices for banks.

In 2004, the EBRD Corporate Governance Sector Assessment compared corporate legislation in the Bank’s countries of operations with the OECD Principles of corporate governance. While the corporate governance framework for banks has improved, corporate governance for JSCs was rated as being in “very low compliance” (see chart below) with international standards, showing several weaknesses especially in the “disclosure and transparency” and “responsibilities of the board” sections.

### *Quality of corporate governance legislation – Azerbaijan (2004)*



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximate these principles

*Source:* EBRD Corporate Governance Sector Assessment, 2004 assessment

In 2005, the EBRD conducted a survey for testing the effectiveness of corporate governance (how the law works in practice). A case study dealing with related-party transactions was designed. The case study investigated (i) the position of a minority shareholder seeking to access corporate information on a presumed related-party transaction was indeed entered into by the company and (ii) how compensation could be obtained in case damage was suffered. Effectiveness of the system for both questions was assessed based on four principal variables: complexity, speed, enforceability and institutional environment.

The survey revealed that there are different legal actions available for a minority shareholder seeking disclosure. Procedures are not deemed particularly complex, but actions can last for more than 18 months which is too long for obtaining disclosure. The situation is similar when looking at redress avenues. The major problem highlighted by the survey is the weak institutional environment. The survey highlighted the low quality of company information and the little competence and experience of courts, prosecutors and market regulator. The use of case law by lawyers and judges is extremely limited and case collections are extremely hard to find. Moreover, judicial proceedings provide the defendants with numerous possibilities for obstruction, without incurring procedural penalties. Finally corruption and partiality of judgements are still reported as problems.

## **Concessions**

Azerbaijan is one of the very few countries in the EBRD region that do not have a single-act concessions law. Instead, the country takes a sector-by-sector approach in regulating concessions. The rights and obligations of concessionaires, as well as the nature of government regulation, vary sector by sector. In addition, some general laws refer to concessions too. As far as the policy framework is concerned there have been documents published, setting out the governmental policy for promoting private sector participation and improving the legal environment.

The Civil Code and the Law on Protection of Foreign Investments do refer to concessions but determine the term and its scope differently. Sector-specific laws do not regulate concessions specifically, but govern other forms of private sector participation. In natural resources, for instance, licenses for exploration or mining can be granted by an executive agency, on the basis of tender offers, auctions, or direct negotiations in special circumstances. The rules aim to ensure everyone has an equal chance to obtain a mining license. Disputes arising under the law can be resolved by the executive agency, as well as in the courts. The law on Power Stations allows private entities, both domestic and foreign, to build, renovate and operate power stations on the basis of special permission from the government.

The general tender procedure is regulated by the Law on Tenders of 1997, as amended. Tenders are conducted by special tender committees. Tenders are usually open, but can be closed - on the basis of invitations - if the number of potential bidders is limited and known, if state security is involved, or, more vaguely, if funds for the tender are so earmarked. All else being equal, contracts are to be awarded to Azeri firms over foreigners. Participants who feel that the committee behaved illegally in its selection can appeal its decision in the courts.

The lack of a consistent concessions specific legal framework weakens the effect of the otherwise quite well written and environmentally progressive individual laws. Thus, despite certain positive elements, the general legal framework for PPP needs to be improved in Azerbaijan.

The 2004/2005 EBRD Concession Laws Assessment, undertaken to evaluate applicable regimes throughout the EBRD's 27 countries of operations, (the law on the books only, rather than how they work in practice), revealed that the laws of Azerbaijan "generally conform with internationally accepted principles of concessions laws". While rules covering settlement of disputes in concession-related arrangements and selection of a concessionaire, for instance, are regulated fairly extensively, most other areas, in particular, the project agreement need dramatic improvement in order to meet the requirements of a modern legal framework facilitating private sector participation.

According to the 2006 Legal Indicator Survey evaluating how the laws work in practice Azerbaijan was one of only five countries that received a "very low" effectiveness rating.

## **Insolvency**

Bankruptcy and insolvency are governed by the Law on Insolvency and Bankruptcy, as amended (the "Insolvency Law"). This law scored "low compliance" when compared with international standards in the EBRD's 2006 Insolvency Sector Assessment. It is deficient in many key areas. Specifically, the Insolvency Law does not provide for a "balance sheet" test for insolvency and does not provide expedited time limits within which an insolvency case must be heard by the court. In addition, the law's provisions on the avoidance of suspicious pre-bankruptcy transactions are vague and do not provide the necessary detail to create a predictable avoidance regime. As regards the unlawful disposal of property after the commencement of insolvency proceedings, the law fails to provide for the speedy recovery of such property.

The Insolvency Law is particularly deficient in addressing the issue of reorganisation. At present, the reorganisation provisions amount to a composition to pay debts in full over a period of time. A meaningful reorganisation scheme, however, should allow for the compromising of obligations to facilitate recovery. Under the current scheme, virtually no ongoing financing during restructuring will be available and the percentage of creditor support required to approve a restructuring plan is too

high. Both of these issues must be addressed. Finally, the law should address the issue of cross-border insolvency proceedings.

Although the insolvency law does contain some positive elements, such as the provision of a stay of proceedings once an insolvency case is opened and clear requirements for the qualification, appointment and removal of an insolvency administrator, there is some doubt as to whether these positive attributes can be positively implemented. The EBRD 2004 Legal Indicator Survey on Insolvency examined the “effectiveness” of the law in practice, clearly showing that the practical application of the Insolvency Law is likely to be unduly expensive and overly complex. In addition, the results of the survey showed that the predictability and competence of judges hearing bankruptcy cases is fairly unreliable. Furthermore, in the case of a creditor, the requirements for commencing an insolvency proceeding against a recalcitrant debtor are needlessly formalistic.

All of these factors, together with the law’s deficiencies, indicate that the insolvency system in the country will not and, indeed, cannot function properly.

### **Secured Transactions**

Taking security over property in Azerbaijan is severely hindered by the existing legal provisions as well as the lack of functioning institutions. Without comprehensive and thorough reforms, the secured credit market will face serious challenges to develop despite growing interest.

Security rights over movable and immovable assets in Azerbaijan are primarily governed by the Civil Code, which entered into force on 1 September 2001, and the Mortgage Law of 2005. The 1998 Pledge Law was repealed at the end of 2006 and the progressive features that it contained have now disappeared. The examples are: the possibility to take a mortgage over the whole or part of a business’ enterprise; the possibility to charge assets that would be generally described or feature in the charging agreement; the possibility for the chargor to sell some of the charged assets in the ordinary course of business with the buyer acquiring them free from the charge (essential if a charge is taken over the whole enterprise); and the possibility for the chargeholder in case of default of the chargor to take possession of the charged assets.

The Civil Code makes its fundamental distinction between pledges and mortgages:

- Pledges can be of various nature: the charged assets can be given in possession to the creditor or not, and can cover intangible assets (e.g. account receivables). Pledges are mostly not registered.
- Mortgages must be registered in the relevant official registry. For movable assets, this refers to existing asset-based registries, such as motor vehicles registry, ship registry, etc.

In a survey conducted by the EBRD in 2003 on enforcement of a charge over a piece of equipment, Azerbaijan’s legal regime was among the least efficient, allowing the secured creditor to recover little of its secured debt, after a lengthy and complex procedure. As the graph below shows, almost all aspects of the enforcement process present difficulties, and the results would be identically mediocre should the scope of enforcement differ (e.g. in case of the debtor’s insolvency or where the collateral would be real estate).

A USAID funded project launched in 2005 is proposing radical changes to the system by the adoption of a new Secured Transactions Law (along the lines of the US UCC Article 9) and the creation of a notice filing system. The draft law and implementing measures are still under discussions at the time of this annex is prepared.

As far as real estate is concerned, the system has suffered for many years of severe uncertainty due to the lack of unified, centralised, and efficient immovable property register for all (this is a typical Soviet heritage, which has been dealt with in most of the former Soviet Union republics).<sup>1</sup> It seems

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<sup>1</sup> Registration of property was scattered among various institutions, inter alia:

that all existing databases have now been transferred to one single entity, namely the State Register Service, which is exclusively responsible for registering transfer of titles, mortgages, and other real property rights. It is unclear whether (i) transfer of data has been accompanied with harmonization and computerization to resolve conflicts and allow easy searching and (ii) the Service is able to provide users – in particular lenders who are increasingly developing mortgage sector – an efficient and reliable system. The 2005 Mortgage Law has compounded the certainty noted above in many important legal and institutional aspects. The legal position for taking mortgages (and also for taking pledges) remains far from clear as do the requirements and procedures for registration.

## **Telecommunications**

The communications sector in Azerbaijan is currently governed by the Telecommunications Law of 1997 (the “1997 Telecom Law”) and is regulated by the Ministry of Communications and Information Technology (MCIT). MCIT was established in February 2004, replacing the Ministry of Telecommunications as both sector policy-maker and regulator. Additionally, MCIT also maintains the state shareholdings in both dominant incumbent Aztelecom and alternative operators.

Aztelecom remains wholly state-owned, with no apparent movement on privatisation of state holdings. The authorities, mostly through MCIT, currently keep a tight control over the sector through requiring operators be in joint venture with the government. This requirement, together with MCIT’s conflicting role as regulator and policy-maker significantly distorts the market and provides scope for political influence on most commercial operations in the sector. While the government has previously indicated an intention to reduce its participation in operations through privatisation, little activity of substance appears to be taking place in this regard. Aztelecom remains wholly state-owned and dominates the fixed-line market with exclusivity on long distance and international calls, including leasing of intercity and international lines. Accordingly, alternative operators have yet to make an impact.

Persistent conflict in MCIT’s roles as policymaker, regulator and shareholder continues to stymie sector growth and retard development. While there has been discussion of a new communications law, the continuing absence of a properly enforced, international standard, legislative framework will make it very difficult for meaningful competition to emerge. Additionally, despite the entrance of a number of alternative operators to the market, prospects for competition continue to be limited due to ongoing exclusivity of Aztelecom, allied to state control over infrastructure and tendencies towards high interconnection fees. Critically, the absence of an independent regulator also significantly hinders development of the sector. On the positive side, however, recent moves to rebalance tariffs are noted as a move in the right direction.

Moving forward, the government should act immediately to address the state’s conflicting role by restricting MCIT’s role to that of sector policymaker and immediately establishing an independent sector specific regulatory authority (separate from MCIT). In tandem with these actions, the government should also immediately full revise the legislative framework incorporating international best practice and adopting the necessary secondary legislation to fully implement frameworks for interconnection, licensing, tariff setting and universal service. Additionally, the government should commit to a precise and definitive timetable for withdrawing the state from its shareholdings in the sector as soon as possible.

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- Land Committee, for titles and other rights over land;
  - Bureaus of Technical Inventory for titles and other rights on residential buildings;
  - State Property Registry (operated by the MoED), for state property;
  - AZAL for the registration of aircraft;
  - State Traffic Division (Ministry of Internal Affairs) for vehicles; and
  - Ministry of Railway for trains, locomotives and other railway vehicles.

## ANNEX 4: THE BANK'S COMMITMENTS AND NET PORTFOLIO

Op Name	Total Project Value	EBRD Finance	Debt	Equity	Guarantee	Disbursed	Portfolio	Undrawn Commitment	Operating Assets*	Portfolio Class	Signing Date
<b>FINANCIAL INSTITUTIONS</b>											
<b>Bank Lending &amp; Bank Equity</b>											
Azerbaijan Multi Bank FW - Azerdemiryolbank	0.5	0.5	0.5	0.0		0.5	0.0	0.0	0.0	Private	14-Jun-99
Azerbaijan Multi Bank FW - IBA	3.0	3.0	3.0	0.0		3.0	0.0	0.0	0.0	Private	21-Jul-98
Azerbaijan Multi Bank FW - Unibank (fka MBank)	2.2	1.1	1.1	0.0		1.1	0.2	0.0	0.2	Private	29-Nov-02
Regional TFP: UniBank (former MBank)	3.9	3.9	3.9	0.0	3.9	1.8	3.9	2.1	1.8	Private	02-Dec-02
Regional TFP: Azerdemiryolbank	3.8	3.8	3.8	0.0	3.8	3.1	3.8	2.1	3.1	Private	08-Nov-02
Unibank Equity Investment	1.2	1.2	0.0	0.9		0.9	0.9	0.0	0.9	Private	05-Sep-03
Regional TFP: Azerigazbank	3.4	3.4	3.4	0.0	3.4	0.0	3.4	3.4	0.0	Private	19-Dec-03
Azerbaijan Multi Bank FW - Bank of Baku	0.7	0.7	0.7	0.0		0.7	0.4	0.0	0.4	Private	13-Feb-04
Regional TFP: Bank of Baku	1.6	1.6	1.6	0.0	1.6	0.4	1.6	1.2	0.4	Private	19-Dec-06
MBASK Insurance Company	1.2	1.2	0.0	0.7		0.7	0.7	0.0	0.7	Private	28-Jan-05
Azerbaijan Multi-Bank FW - Bank Respublika	0.7	0.7	0.7	0.0		0.7	0.5	0.0	0.5	Private	27-Sep-04
Azerbaijan Multi Bank FW - Azerdemiryolbank (II)	1.5	1.5	1.5	0.0		1.5	1.1	0.0	1.1	Private	27-Sep-04
Azerbaijan Multi Bank FW - Azerigazbank	1.5	1.5	1.5	0.0		1.5	0.6	0.0	0.6	Private	27-Sep-04
Unibank A/B Loan	7.4	1.1	1.1	0.0		1.1	0.7	0.0	0.7	Private	08-Apr-05
Regional TFP: Bank Respublika	4.8	4.8	4.8	0.0	4.8	0.0	4.8	4.8	0.0	Private	27-Sep-04
Azerbaijan Multi-Bank FW: Bank of Baku (II)	0.7	0.7	0.7	0.0		0.7	0.3	0.0	0.3	Private	16-Feb-05
Bank of Baku Equity Investment (Azerbaijan)	3.7	3.7	0.0	3.7		0.0	3.7	3.7	0.0	Private	14-Oct-05
Azerdemiryol Bank Equity Investment	2.1	2.1	0.0	2.1		2.1	2.1	0.0	2.1	Private	23-Nov-05
Azerbaijan Multi Bank FW - Bank Respublika (II)	1.5	1.5	1.5	0.0		1.5	1.2	0.0	1.2	Private	14-Oct-05
Azerbaijan Multi Bank FW - Azerigazbank (II)	1.1	1.1	1.1	0.0		1.1	1.0	0.0	1.0	Private	14-Oct-05
Unibank Capital Increase	2.6	2.6	0.0	2.6		2.6	2.6	0.0	2.6	Private	27-Jun-07
Unibank A/B loan - II	5.6	1.9	1.9	0.0		1.9	1.9	0.0	1.9	Private	07-Sep-06
Azerbaijan Multi-Bank Fram - Bank of Baku (III)	3.3	3.3	3.3	0.0		3.3	3.3	0.0	3.3	Private	20-May-06
Azerbaijan Multi-Bank Framework - Unibank (II)	1.5	1.5	1.5	0.0		0.8	1.5	0.7	0.8	Private	20-May-06
Azerbaijan Multi Bank FW - Bank Respublika (III)	1.5	1.5	1.5	0.0		1.5	1.5	0.0	1.5	Private	20-May-06
Azerbaijan Multi Bank FW - Azerdemiryolbank (III)	3.7	3.7	3.7	0.0		3.7	3.7	0.0	3.7	Private	20-May-06
Azerbaijan Multi Bank FW - Mugan Bank	1.5	1.5	1.5	0.0		1.0	1.5	0.5	1.0	Private	27-Nov-06
Azerbaijan Multi Bank FW - Nikoil Bank	1.5	1.5	1.5	0.0		0.0	1.5	1.5	0.0	Private	14-Feb-07
Azerbaijan Multi Bank FW - Azerigazbank (IV)	4.4	4.4	4.4	0.0		0.0	4.4	4.4	0.0	Private	20-May-07
MCFF - Bank of Baku Full Recourse Portion	1.9	1.9	1.9	0.0		1.5	1.9	0.4	1.5	Private	21-Dec-06
MCFF - Azerdemiryolbank Full Recourse Portion	0.7	0.7	0.7	0.0		0.0	0.7	0.7	0.0	Private	25-May-07
MCFF - Bank Respublika Full Recourse Portion	1.1	1.1	1.1	0.0		0.0	1.1	0.1	0.0	Private	13-Dec-06
<b>Subtotal Bank Lending and Bank Equity</b>	<b>75.8</b>	<b>64.7</b>	<b>53.9</b>	<b>10.0</b>	<b>17.5</b>	<b>38.7</b>	<b>56.5</b>	<b>25.6</b>	<b>31.3</b>		
<b>Small Business Finance</b>											
Microfinance Bank Azerbaijan (MFBA)	7.7	4.9	3.7	1.2		4.9	4.9	0.0	4.9	Private	28-Jun-02
ETC Non-Bank MFI Framework II - FINCA (Azerbaijan)	2.2	1.9	1.9	0.0		1.9	1.9	0.0	1.9	Private	15-Nov-05
Azeri Multi Bank Framework - Azerdemiryolbank (MSE)	0.7	0.7	0.7	0.0		0.7	0.7	0.0	0.7	Private	23-Nov-05
Azeri Multi-Bank Framework - Bank Respublika (MSE)	1.5	1.5	1.5	0.0		1.5	1.5	0.0	1.5	Private	19-Dec-05
Azeri Multi-Bank Framework - Unibank (MSE)	1.5	1.5	1.5	0.0		1.5	1.5	0.0	1.5	Private	19-Dec-05
ETC Non Bank MFI FW - CredAgro	0.7	0.6	0.6	0.0		0.6	0.6	0.0	0.6	Private	26-Sep-06
Azeri Multi-Bank Framework - Azerigazbank (MSE)	1.5	1.5	1.5	0.0		1.5	1.5	0.0	1.5	Private	11-Apr-06
Azeri Multi-Bank Framework - Rabitabank MSME Loan	2.2	1.5	1.5	0.0		0.9	1.5	0.6	0.9	Private	15-Nov-06
Microfinance Bank Azerbaijan (MFBA) - Equity	1.0	0.9	0.0	0.9		0.0	0.9	0.0	0.9	Private	11-Dec-06
<b>Subtotal Small Business Finance</b>	<b>19.0</b>	<b>15.0</b>	<b>12.9</b>	<b>2.1</b>	<b>0.0</b>	<b>13.5</b>	<b>15.0</b>	<b>0.6</b>	<b>14.4</b>		
<b>Non Bank Financial Institutions</b>											
Unileasing - Equity	0.5	0.5	0.0	0.5		0.5	0.5	0.0	0.5	Private	14-Mar-07
Unileasing - debt	2.2	2.2	2.2	0.0		0.0	2.2	2.2	0.0	Private	14-Mar-07
<b>Subtotal Non Bank Financial Institutions</b>	<b>2.7</b>	<b>2.7</b>	<b>2.2</b>	<b>0.5</b>	<b>0.0</b>	<b>0.5</b>	<b>2.7</b>	<b>2.2</b>	<b>0.5</b>		
<b>Equity Funds</b>											
AIG Silk Road Fund	13.5	3.3	0.0	3.3		2.3	1.0	1.0	0.0	Private	25-Sep-97
Baring Vostok Private Equity Fund	4.0	1.8	0.0	1.8		0.8	0.2	0.2	0.0	Private	13-Dec-00
First NIS Regional Fund	0.5	0.3	0.0	0.3		0.3	0.3	0.3	0.0	Private	21-Nov-94
<b>Subtotal Equity Funds</b>	<b>18.0</b>	<b>5.4</b>	<b>0.0</b>	<b>5.4</b>	<b>0.0</b>	<b>3.4</b>	<b>1.5</b>	<b>1.5</b>	<b>0.0</b>		
<b>Total Financial Institutions</b>	<b>115.5</b>	<b>87.8</b>	<b>69.0</b>	<b>18.0</b>	<b>17.5</b>	<b>56.1</b>	<b>75.7</b>	<b>29.9</b>	<b>46.2</b>		

<b>ENERGY</b>											
<b>Power &amp; Energy</b>											
Yenikend Renewable Energy Project	55.6	39.4	39.4	0.0		39.4	9.0	0.0	9.0	Sovereign	21-Dec-94
Mingechar Power Project	35.7	16.0	16.0	0.0		16.0	7.4	0.0	7.4	Sovereign	24-Jun-97
AZDRES Power Plant Rehabilitation	95.1	85.1	85.1	0.0		0.0	85.1	85.1	0.0	Sovereign	01-Nov-06
<b>Subtotal Power &amp; Energy</b>	<b>186.4</b>	<b>140.5</b>	<b>140.5</b>	<b>0.0</b>	<b>0.0</b>	<b>55.4</b>	<b>101.5</b>	<b>85.1</b>	<b>16.4</b>		
<b>Natural Resources</b>											
Chirag Early Oil - AMOCO Caspian Sea Finance Ltd	429.2	24.3	24.3	0.0		24.3	0.0	0.0	0.0	Private	17-Dec-98
Chirag Early Oil - LUKOIL Overseas	252.5	14.3	14.3	0.0		14.3	0.0	0.0	0.0	Private	30-Dec-98
Chirag Early Oil - Turkish Petroleum	170.2	9.6	9.6	0.0		9.6	0.0	0.0	0.0	Private	17-Dec-98
Chirag Early Oil - UNOCAL	253.8	14.4	14.4	0.0		14.4	0.0	0.0	0.0	Private	17-Dec-98
Chirag Early Oil	201.6	11.4	11.4	0.0		11.4	0.0	0.0	0.0	Private	17-Dec-98
Nations Azerbaijan (ex Moncrief Azerb. Oil Company	70.8	43.8	38.2	5.6		43.8	0.0	0.0	0.0	Private	21-Aug-00
SOCAR - Shah Deniz Gas Condensate Field Development	410.9	28.5	28.5	0.0		28.5	0.0	0.0	0.0	Private	04-Nov-04
SOCAR - South Caucasus Gas Pipeline	52.1	9.2	9.2	0.0		9.2	0.0	0.0	0.0	Private	04-Nov-04
ACG Phase I - Amerada Hess	5.1	1.2	1.2	0.0		1.2	0.0	0.0	0.0	Private	03-Feb-04
ACG Phase I - Amoco Caspian Sea Finance Ltd.	30.5	7.4	7.4	0.0		7.4	0.0	0.0	0.0	Private	03-Feb-04
ACG Phase I - Statoil Absheron Finance A/S	16.9	1.9	1.9	0.0		1.9	0.0	0.0	0.0	Private	03-Feb-04
ACG Phase I - UNOCAL Phase I Finance Ltd.	29.6	7.4	7.4	0.0		7.4	0.0	0.0	0.0	Private	03-Feb-04
Lukoil Overseas: Shah Deniz Gas Condensate Field Develo	205.0	81.4	81.4	0.0		0.0	81.4	81.4	0.0	Private	28-Jul-05
Frontera Resources	211.3	9.6	9.6	0.0		9.6	0.0	0.0	0.0	Private	15-May-00
Baku-Tbilisi-Ceyhan (BTC) Pipeline	962.0	46.3	46.3	0.0		46.3	46.3	0.0	46.3	Private	03-Feb-04
Lukoil Overseas : South Caucasus Gas Pipeline	46.8	30.1	30.1	0.0		0.0	30.1	30.1	0.0	Private	28-Jul-05
<b>Subtotal Natural Resources</b>	<b>3,348.3</b>	<b>340.8</b>	<b>335.2</b>	<b>5.6</b>	<b>0.0</b>	<b>229.3</b>	<b>157.8</b>	<b>111.5</b>	<b>46.3</b>		
<b>Total Energy</b>	<b>3,534.7</b>	<b>481.3</b>	<b>475.7</b>	<b>5.6</b>	<b>0.0</b>	<b>284.7</b>	<b>259.3</b>	<b>196.6</b>	<b>62.7</b>		
<b>INFRASTRUCTURE</b>											
<b>Municipal &amp; Environmental Infrastructure</b>											
Baku Water Rehabilitation Project	80.6	16.8	16.8	0.0		16.8	4.6	0.0	4.6	Sovereign	16-Oct-95
<b>Subtotal Municipal &amp; Environmental Infrastructure</b>	<b>80.6</b>	<b>16.8</b>	<b>16.8</b>	<b>0.0</b>	<b>0.0</b>	<b>16.8</b>	<b>4.6</b>	<b>0.0</b>	<b>4.6</b>		
<b>Transport</b>											
Baku Port Development	4.7	0.1	0.1	0.0		0.1	0.0	0.0	0.0	Sovereign	10-Dec-99
Azerbaijan: Silk Road	35.2	30.4	30.4	0.0		18.7	30.4	11.6	18.7	Sovereign	22-Jul-04
Baku to Samur	81.2	74.0	74.0	0.0	46.0	0.7	74.0	73.3	0.7	Sovereign	29-Sep-05
Air Navigation Systems Upgrading	11.5	10.1	10.1	0.0		10.1	11.5	0.0	11.5	Sovereign	21-Dec-96
Azerbaijan: Trans-Caucasian Rail Link Project	27.3	15.0	15.0	0.0		15.0	9.3	0.0	9.3	Sovereign	10-Dec-99
<b>Subtotal Transport</b>	<b>159.9</b>	<b>129.6</b>	<b>129.6</b>	<b>0.0</b>	<b>46.0</b>	<b>44.6</b>	<b>125.2</b>	<b>84.9</b>	<b>40.2</b>		
<b>Total Infrastructure</b>	<b>240.5</b>	<b>146.4</b>	<b>146.4</b>	<b>0.0</b>	<b>46.0</b>	<b>61.4</b>	<b>129.8</b>	<b>84.9</b>	<b>44.8</b>		
<b>SPECIALISED INDUSTRY</b>											
<b>Agribusiness</b>											
Milk-Pro LLC	4.1	4.1	3.5	0.6		0.2	4.1	4.0	0.2	Private	19-Nov-04
Milk-Pro LLC Unsecured Loan	1.2	1.2	1.2	0.0		0.0	1.2	1.2	0.0	Private	19-Nov-04
DLF - Aqua Vita	3.3	3.3	3.3	0.0		0.0	3.3	3.3	0.0	Private	27-Sep-06
MCFE - Avrova	0.7	0.4	0.4	0.0		0.0	0.4	0.0	0.4	Private	26-Apr-07
<b>Subtotal Agribusiness</b>	<b>9.3</b>	<b>9.0</b>	<b>8.4</b>	<b>0.6</b>	<b>0.0</b>	<b>0.2</b>	<b>9.0</b>	<b>8.5</b>	<b>0.6</b>		
<b>Property &amp; Tourism</b>											
Landmark I (Neptun)	4.6	2.3	2.3	0.0		2.3	0.0	0.0	0.0	Private	18-Dec-03
Landmark II (Libra)	3.0	1.5	1.5	0.0		1.5	0.0	0.0	0.0	Private	18-Dec-03
DIF - Silk Road Motel - Garadagh	4.9	1.8	1.8	0.0		1.8	0.0	0.0	0.0	Private	29-Nov-99
<b>Subtotal Property &amp; Tourism</b>	<b>12.5</b>	<b>5.6</b>	<b>5.6</b>	<b>0.0</b>	<b>0.0</b>	<b>5.6</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>		
<b>Total SI</b>	<b>21.8</b>	<b>14.6</b>	<b>14.0</b>	<b>0.6</b>	<b>0.0</b>	<b>5.8</b>	<b>9.0</b>	<b>8.5</b>	<b>0.6</b>		
<b>GENERAL INDUSTRY</b>											
Garadagh Cement	10.0	7.5	0.0	7.5		0.5	7.5	0.0	7.5	Private	21-Dec-06
MCFE - Baku Electronics	3.0	1.5	1.5	0.0		0.7	1.1	0.7	0.4	Private	12-Apr-07
<b>Subtotal General Industry</b>	<b>13.0</b>	<b>9.0</b>	<b>1.5</b>	<b>7.5</b>	<b>0.0</b>	<b>1.2</b>	<b>8.6</b>	<b>0.7</b>	<b>7.9</b>		
<b>Total GI</b>	<b>13.0</b>	<b>9.0</b>	<b>1.5</b>	<b>7.5</b>	<b>0.0</b>	<b>1.2</b>	<b>8.6</b>	<b>0.7</b>	<b>7.9</b>		
<b>TOTAL (all sectors)</b>	<b>3,925.5</b>	<b>739.1</b>	<b>706.6</b>	<b>31.7</b>	<b>63.5</b>	<b>409.2</b>	<b>482.4</b>	<b>320.6</b>	<b>162.2</b>		

## ANNEX 5: INDICATIVE PROJECT PIPELINE

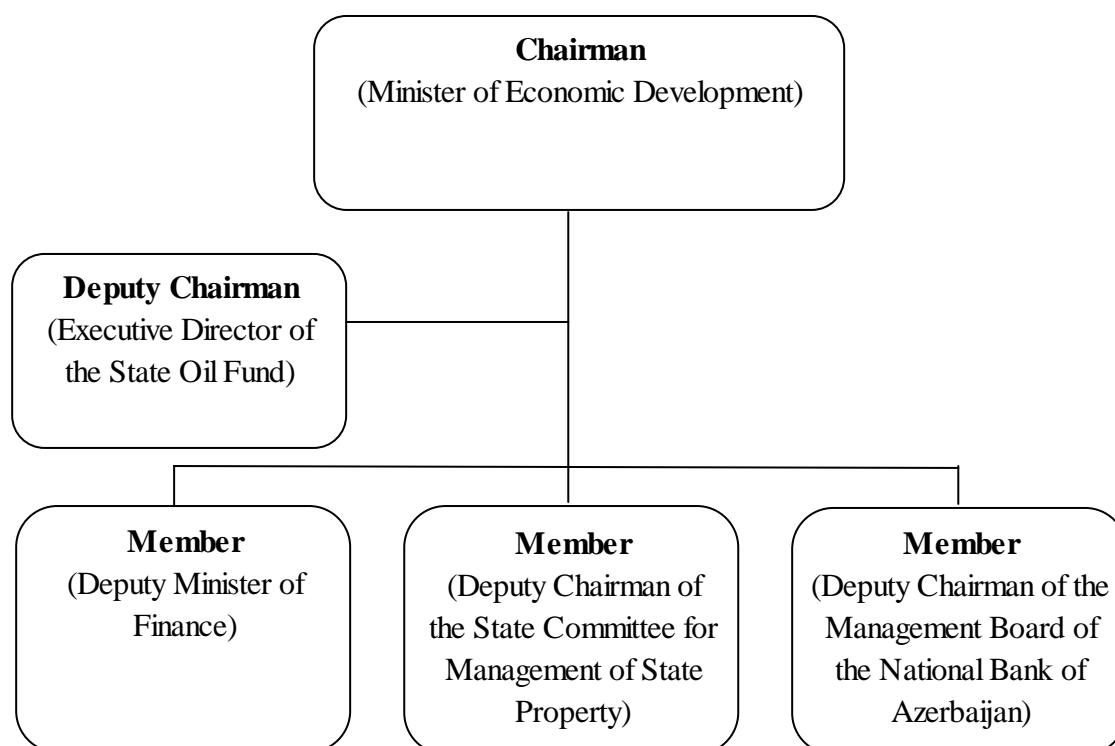
	Number of transactions	Amount (EUR million)	% of Grand Total
<b>ENTERPRISE SECTOR (non-oil and gas)</b>			
General Industries	9	192.6	33.3%
Agribusiness	3	7.1	1.2%
Property and tourism	3	100.0	17.3%
<b>TOTAL</b>	<b>15</b>	<b>299.7</b>	<b>51.8%</b>
<b>FINANCIAL INSTITUTIONS AND GSB</b>			
Financial institutions	5	19.2	3.3%
Group for small business	11	23.1	4.0%
<b>TOTAL</b>	<b>16</b>	<b>42.3</b>	<b>7.3%</b>
<b>INFRASTRUCTURE</b>			
Transport	3	145.0	25.0%
Municipal and environmental infrastructure	1	40.0	6.9%
<b>TOTAL</b>	<b>4</b>	<b>185</b>	<b>32.0%</b>
<b>ENERGY</b>			
Power and Energy	1	50.0	8.6%
Natural Resources	1	1.9	0.3%
<b>TOTAL</b>	<b>2</b>	<b>51.9</b>	<b>9.0%</b>
<b>GRAND TOTAL</b>	<b>37</b>	<b>578.9</b>	<b>100.0%</b>

## ANNEX 6: AZERBAIJAN INVESTMENT COMPANY

Azerbaijan Investment Company ('AIC') has been established by the Decree of the President of the Republic of Azerbaijan dated March 30, 2006. The core mission of the AIC is to support diversification of the economy of Azerbaijan through making direct equity investments mostly in the companies forming the country's non-oil sector. In particular the objectives of the organization are to: (i) invest in existing or newly established commercial enterprises; (ii) attract foreign and stimulate local direct investments into the non-oil sector; (iii) promote development of domestic capital market, and; (iv) contribute in improvement of the country's investment climate.

The AIC operates as an open joint-stock company and has a capital of AZN 90 million (approximately \$100 million) funded by the State Oil Fund of Azerbaijan. The capital of the organization can be increased, if required, through emission of additional shares or bonds. The stock of the AIC is kept with and managed by the Ministry of Economic Development of Azerbaijan.

The AIC's supreme administration body is the Supervisory Board (SB), which, inter alia, approves each project and defines the AIC's exit strategy. SB is chaired by the Minister of Economic Development (see below diagram for the full structure of the SB). Day-to-day operations of the AIC are managed by an Executive Director, whose appointment was approved by the SB.



The AIC's investment principles are similar to those applied by the Bank in equity financing. In particular the organization is a financial investor acquiring a minority stake (having not more than 20 percent of an investee's capital) with a limited time horizon and defined exit strategy. While assessing a project the AIC looks at commercial fundamentals of a business not overlooking the issues related with financial transparency and corporate governance practices applied by the target company. The project evaluation process envisages for in-depth technical and commercial/financial due diligence. As a shareholder, AIC participates, at a strategic level, in the management of its investees through appointing its representative to a board of directors and/or supervisory board.

The AIC welcomes co-investment opportunities with other financial organizations including portfolio investors and equity funds, and is prepared to be flexible while discussing conditions of such co-operation. The decree establishing AIC, however, granted it with broad (unspecified) veto rights on

any operational decision taken by investee's management. Since this naturally raised serious concerns among potential partners, the issue has been brought to the attention of the Government. The Bank, through an active policy dialogue, strongly advised the Ministry of Economic Development to remove the section in the AIC's Charter on the veto rights. The Presidential Decree in this effect was signed on 18 May 2007.

AIC is very keen to work and finance projects alongside EBRD and other reputable investors. AIC sees significant value in this cooperation as it will be able to benefit from the Bank's vast experience in equity financing. At the same time, having the Bank as a co-investor will increase the AIC's profile and improve its reputation vis-à-vis local and foreign investors. Co-operation between the AIC and the Bank started in 2006, when at the request of the Government, the Bank has provided technical assistance to the AIC, and appointed an experienced consultant who assisted the organization in preparing its charter and the investment assessment, approval and monitoring procedures. In May 2007, AIC purchased a 20 per cent stake in Milk-Pro (a dairy company) where the Bank held a 25 per cent stake. As a result of this transaction, the Bank stake in Milk-Pro decreased to 10 per cent. The proceeds of AIC equity contribution will be utilized for construction of a new up to date dairy processing plant in Baku. In addition, the AIC seriously considers investment in Garadagh Cement Company (majority owned by a Swiss parent), in which EBRD has a 10 per cent stake. Garadagh Cement is the largest cement producer in Azerbaijan and supplies about 50 per cent of all cement consumed in the country.

## ANNEX 7: TECHNICAL COOPERATION

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved Date	Commit. Stage Name	Sector	Linked to Inv.
TurnAround Management Programme - Salyan plastic products	31,917	31,917	17/08/98	Closed	Manufacturing	N
Preparation of power sector efficiency improvement project	225,008	225,008	20/02/95	Closed	Energy	Y
EU TAM Programme in Azerbaijan	396,699	396,699	30/08/02	Closed	Manufacturing	N
EU BAS Programme in Azerbaijan	654,959	654,959	07/10/02	Closed	Manufacturing	N
Air navigation systems upgrading project	299,726	299,726	22/06/95	Closed	Transport, Storage	Y
Azerbaijan Micro Finance Bank: Pre-oper and Oper Phases	1,181,217	1,181,217	18/12/01	Closed	Finance, Business	Y
Baku Port Development, Consultancy Services for PIU support	284,415	284,415	29/04/02	Closed	Transport, Storage	Y
Twinning programme for SME line of credit and pre-privatisation of International Bank	910,458	910,458	01/11/96	Closed	Finance, Business	Y
Institutional Development Programme for SME line of credit of Azerdemiryolbank	491,380	491,380	27/11/96	Closed	Finance, Business	Y
Development of Cost Accounting and Management Information Systems	299,012	299,012	14/05/97	Closed	Transport, Storage	Y
Final design of the Gazi Mammed to Kyurdamir road	353,031	353,031	02/07/97	Closed	Construction	Y
Multi-bank SME framework financing facility - Institutional Development Programme - Arkobank	317,781	317,781	28/11/97	Closed	Finance, Business	Y
Multi-bank SME framework financing facility - Institutional Development Programme - Azerigazbank	435,654	435,654	28/11/97	Closed	Finance, Business	Y
Azerbaijan Micro Finance Bank ("AMB"): Micro and Small Enterprise Credit Advisors	406,377	406,377	18/12/01	Closed	Finance, Business	Y
Final design of the Gazi Mammed to Kyurdamir road	364,162	364,162	20/07/98	Closed	Construction	Y
Institutional development and financial management of Baku Port	990,682	990,682	24/07/98	Closed	Transport, Storage	Y
Trans-Caucasian Rail Link: Assistance with Project Implementation	234,704	234,704	03/11/98	Closed	Manufacturing	Y
Azerbaijan Railways: Accounts Strengthening & Business Planning	293,515	293,515	27/09/00	Closed	Transport, Storage	Y
Central Credit Advisory Services	400,723	400,723	19/12/00	Closed	Finance, Business	Y
Trans-Caucasian Rail Link: Assistance with Project Implementation	286,993	286,993	14/11/01	Closed	Manufacturing	Y
Central Credit Advisory Services	298,327	298,327	08/07/02	Closed	Finance, Business	Y
Credit advisory services - Azerdemiryolbank	59,794	59,794	30/09/99	Closed	Finance, Business	Y
Preparation of tender documents, procurement assistance and supervision of works - Baku Port	393,977	393,977	08/12/99	Closed	Transport, Storage	Y
Azerbaijan Micro Finance Bank (AMB)	273,990	273,990	12/12/02	Closed	Finance, Business	Y
Microfinance Bank of Azerbaijan (MFBA) - Regional Expansion	795,379	795,379	07/05/04	Closed	Finance, Business	Y
TransCaucasian Rail Link, Project Mngt Consulting	132,555	132,555	08/09/04	Closed	Transport, Storage	Y
MBASK - Institutional Strengthening Programme	180,324	180,324	07/12/04	Closed	Finance, Business	Y
Azerbaijan - Credit Advisory Services	298,750	298,750	30/06/03	Closed	Finance, Business	Y

Azerbaijan - Institutional Strengthening of Unibank	255,495	255,495	18/05/04	Closed	Finance, Business	Y
Microfinance Bank of Azerbaijan (MFBA) Expansion	778,611	778,611	18/11/04	Closed	Finance, Business	Y
Azerbaijan - Central Credit Advisory Services Expansion	271,474	271,474	30/09/04	Closed	Finance, Business	Y
Hajigabul-Kurdamiir Road, Lender's Monitoring Consultant	195,810	108,350	15/12/04	Disbursing	Transport, Storage	Y
Baku to Samur Road: Lenders Monitoring Consultant	110,284	3,944	27/06/05	Disbursing	Transport, Storage	Y
Central Credit Advisory Services Extension	470,000	368,338	25/08/05	Disbursing	Finance, Business	Y
MBASK - IT Development and MIS Upgrade	195,000	59,731	15/06/06	Disbursing	Finance, Business	Y
Implementation of Bank of Baku/Ilkbank Institutional Building Programme	200,000	0	20/04/05	Committed	Finance, Business	Y
Assistance to the Road Transport Services Department (RTSD) in the Implementation of the Corporate Plan	400,000	0	28/06/05	Committed	Transport, Storage	Y
Azerbaijan: Azerdemiryolbank - Implementation of Institution Building Plan	300,000	21,326	17/11/05	Disbursing	Finance, Business	Y
Azeri Multi-Bank Framework Facility: MSE Credit Advisers	550,000	461,936	13/12/05	Disbursing	Finance, Business	Y
TAM - REM Services	21,531	12,685	27/01/06	Disbursing	Manufacturing	N
TAM - Embawood	16,712	16,651	27/01/06	Disbursing	Manufacturing	N
TAM - Bakfem	85,500	41,032	12/05/06	Disbursing	Manufacturing	N
Azerbaijan: Azeri Multi-Bank Framework Facility - MSE Credit Advisers 2007	542,000	0	17/10/06	Committed	Finance, Business	Y
Unileasing - Institutional Strengthening	250,000	0	30/11/06	Committed	Finance, Business	Y
AzDRES Power Plant Rehabilitation Project - Health & Safety	600,000	0	30/11/06	Committed	Energy	Y
Azerbaijan - Technical Support to Electricity Tariff Council	200,000	0	30/11/06	Committed	Energy	Y
TAM - Caspian Supplies	74,440	9,614	07/12/06	Disbursing	Manufacturing	N
Azerbaijan: A)Multi Bank Financing Framework Facility - Credit Advisory Services and Institution Building; B)Medium Sized Co-financing Facility (MCFF) - Advisory Services to Participating Banks	600,000	0	23/04/07	Committed	Finance, Business	Y
TurnAround Management Programme - Baku Chemistry Pharmaceutical Factory	25,677	25,677	11/09/98	Closed	Manufacturing	N
Foreign investment protection law	32,267	32,267	18/06/96	Closed	Community/Social Services	N
Gazzi Mammed - Kyurdamiir Road : Revisions to Designs	77,160	77,160	20/04/04	Closed	Transport, Storage	Y
Azerbaijan: Trade Finance Advisory Services	64,400	64,400	07/02/05	Closed	Finance, Business	Y
TurnAround Management Programme - Mingechaur Textile Company	38,072	38,072	17/08/98	Closed	Community/Social Services	N
Azerbaijan Microfinance Bank - Feasibility Study	84,885	84,885	26/06/00	Closed	Finance, Business	Y
Law reform - bankruptcy legislation	11,723	11,723	01/08/96	Closed	Community/Social Services	N
Turnaround Management Programme (TAM) - SPU "Bakkonditioner"	15,179	15,179	15/02/01	Closed	Manufacturing	N
Azerbaijan - M-Pro Investment Support TC	140,000	28,566	08/02/05	Disbursing	Manufacturing	Y
Trans-Caucasian rail link in Azerbaijan - project identification	49,615	49,615	17/11/97	Closed	Manufacturing	Y
TurnAround Management Programme - ATEF	27,289	27,289	10/05/99	Closed	Community/Social Services	N
Azerbaijan ICT Programme	22,767	17,587	20/09/05	Disbursing	Manufacturing	N
TAM - Azerbaijan ICT	62,733	24,885	23/06/06	Disbursing	Manufacturing	N

Baku to Astara road improvement project	38,199	38,199	08/05/96	Closed	Construction	Y
Baku port development	46,272	46,272	07/01/97	Closed	Transport, Storage	Y
Energy savings and efficiency improvement study	147,914	147,914	17/05/93	Closed	Energy	Y
Yenikend power sector - feasibility study	171,579	171,579	15/06/94	Closed	Energy	Y
Turnaround Management Programme - SPU Bakkonditioner	50,993	50,993	30/03/01	Closed	Manufacturing	N
Yenikend Power - commercial management system	400,000	400,000	01/10/94	Closed	Energy	Y
Wholesale market	103,454	103,454	01/10/95	Closed	Manufacturing	Y
ANS Procurement arrangements - Azerbaijan Airlines - state concern for civil aviation (AZAL)	217,849	217,849	14/06/96	Closed	Community/Social Services	Y
Yenikend power - procurement arrangements	168,370	168,370	05/09/94	Closed	Energy	Y
Developing Azerbaijan's National Oil Spill Contingency Plan	220,760	220,760	26/06/03	Closed	Extractive Industries	N
Mortgage Registration in Azerbaijan	65,777	65,777	30/11/04	Closed	Community/Social Services	N
Wholesale market	55,512	55,512	25/07/95	Closed	Manufacturing	Y
FAO Framework Agreement - identification of investment opportunities in the agrifood sector	16,201	16,201	31/05/01	Closed	Manufacturing	N
Yenikend power sector rehabilitation - environmental assistance	54,846	54,846	07/07/94	Closed	Energy	Y
Advisory services for telecommunications investment planning	14,168	14,168	19/07/95	Closed	Telecommunications	Y
Development of secured transactions law	22,984	22,984	01/11/95	Closed	Community/Social Services	N
Law reform - bankruptcy legislation	95,642	95,642	29/08/96	Closed	Community/Social Services	N
TurnAround Management Programme - Salyan plastic products	12,348	12,348	05/08/98	Closed	Manufacturing	N
TurnAround Management Programme - Mingechaur Textile Company	10,839	10,839	05/08/98	Closed	Community/Social Services	N
TurnAround Management Programme - Baku Chemistry Pharmaceutical Factory	8,260	8,260	15/09/98	Closed	Community/Social Services	N
Turnaround Management Programme for Azertrans JSC	9,994	9,994	23/04/99	Closed	Manufacturing	N
TurnAround Management Programme - ATEF	7,564	7,564	23/04/99	Closed	Community/Social Services	N
Legal Advisory Services to Azerbaijan in connection with Drafting Securities Market-related Primary Laws	48,895	48,895	31/10/01	Closed	Community/Social Services	N
ADDY 2: Assistance with Project Preparation	49,728	49,728	27/01/03	Closed	Transport, Storage	Y
Azerbaijan: Prioritisation of Investment Needs in Power Generation and Transmission	253,392	253,392	11/12/02	Closed	Energy	Y
SOCAR commercialisation and restructuring	549,696	549,696	08/03/04	Closed	Extractive Industries	Y
	<b>20,901,365</b>	<b>17,039,232</b>				
<b>No of Commitments:</b>		<b>87</b>				

## ANNEX 8: ACTIVITIES OF OTHER IFIs AND DONORS

A large number of IFIs and bi-lateral donors are active in Azerbaijan. Below is a summary of the activities of selected IFIs and donor agencies.

### **European Union (EU)**

Between 1992 and 2004, the EC allocated a total of €400 million of grant based assistance to Azerbaijan under the TACIS, ECHO, Food Security, FEOGA, Exceptional Assistance, Rehabilitation and Exceptional Humanitarian Aid programmes. The general objective under the TACIS programme was to assist in the transition to a market economy and pluralist democracy based on human rights with specific initiatives for institutional, legal and administrative reform and private sector development.

The principal objective of cooperation between the EU and Azerbaijan in the coming years is to support the Country's reform agenda and to develop an increasingly close relationship, principally within the framework of the policy objectives defined in the Partnership and Cooperation Agreement (PCA) of June 1999 and the EU-Azerbaijan ENP Action Plan of 14 November 2006. The EC-Azerbaijan Country Strategy Paper (CSP) for 2007-2013, which was adopted by the Commission in March 2007, provides a comprehensive overview of future EC assistance priorities encompassing all instruments and programmes.

The National Indicative Programme (NIP) defines in greater detail the focus of operations under the national envelope of €2 million under the new European Neighbourhood and Partnership Instrument (ENPI). It will focus on three priority areas i) Support for Democratic Development and Good Governance (public administration reform and public finance, rule of law and judicial reform, human rights, civil society development and local government, education, science and people-to-people contacts/exchanges ii) Support for socio-economic reform (emphasis on regulatory approximation with the EU acquis), fight against poverty and administrative capacity building (including trade, investment climate) iii) Support for legislative and economic reforms in the transport, energy and environment sectors.

In the energy sector, the EU signed a Memorandum of Understanding with Azerbaijan on 7 November 2006 which serves as a principal instrument for co-operation. Energy co-operation is also supported at multilateral level via the "Baku Initiative", launched on the occasion of the Energy Ministerial Conference held in Baku on 13 November 2004 with the support of INOGATE.

Azerbaijan has also played an active part in the work of the High Level Group on the extension of major trans-European transport corridors to neighbouring countries and regions, the EU-Black Sea Caspian Basin Ministerial Conferences on Transport and Energy and the follow-up working groups as well as in TRACECA and INOGATE. It constitutes an important partner in the EU's strategy to strengthen links with Central Asia.

The MoU of the tripartite agreement between the EC, EBRD and EIB signed in December 2006 for cooperation in Eastern Europe, the Southern Caucasus and in Russia under the EIB External Mandate will provide additional opportunities for coordinated investments in transport, energy, telecommunications and environmental infrastructure in Azerbaijan.

EC-EBRD cooperation has mainly consisted of support to business (TAM/BAS) and credit advisory services, SME and micro credit lines and design, institutional building and implementation components linked to a number of infrastructure projects (road, railways, air navigation).

### **European Investment Bank (EIB)**

EIB is preparing to commence activities in Azerbaijan. In line with an EU Council Decision of 19 December 2006, the new general mandate for EIB for the period 2007-2013 includes an amount of EUR 3.7 billion for Southern Caucasus (Armenia, Azerbaijan and Georgia), Russia as well as Eastern Europe (Ukraine, Moldova and - subject to future Council agreement - Belarus), no particular allocation per country being prescribed within this amount of EUR 3.7 billion. EIB is currently in

discussions with the authorities of Azerbaijan with a view to signing a Framework Agreement and becoming fully operational in the country as soon as possible. In line with the afore-mentioned mandate as well as the Memorandum of Understanding signed in December 2006 between the EBRD and the EC in liaison with the EIB with respect to Cooperation in Eastern Europe, the Southern Caucasus, in Russia and in Central Asia, the EIB plans to work with the EBRD in Azerbaijan.

The EIB's afore-mentioned mandate to the extent applicable to Azerbaijan is for "projects of significant interest to the EU in transport, energy, telecommunications and environmental infrastructure. Priority will be given to projects on extended major Trans European Network axes, projects with cross-border implications for one or more Member States and major projects favouring regional integration through increased connectivity. In the energy sector, strategic energy supply and energy transport projects are of particular importance. The EBRD will cooperate with EIB in the form of co-financing, consultation and exchange of information, technical assistance, project preparation and appraisal. The EC, through its European Neighbourhood and Partnership Instrument (ENPI) will provide funding for technical assistance to help prepare projects to be co-financed between the EIB and EBRD.

### **The World Bank (WB)**

Azerbaijan became member of the World Bank Group in 1992. The WB has helped improve the management of Azerbaijan's oil fund. The institution has also played a key role in the privatization and distribution of 99 percent of the country's farmland. As part of this effort, small-scale farmers raised their productivity thanks to greater access to advice and information. In the social sector, WB assistance has been used to help refugees and internally displaced people and, in the area of education, schools have been rehabilitated and teachers trained. Over the last four years, the WB has helped the Government establish a meaningful poverty reduction strategy and has supported implementation of important pro-poor reforms in a number of sectors of the economy.

Azerbaijan has already begun the transition from International Development Association (IDA) to International Bank for Reconstruction and Development (IBRD) financing due to its rapidly growing economy and creditworthiness. Its first IBRD loan was approved in May 2005. In fiscal year 2006, World Bank commitments to the country totalled \$300.8 million. Overall commitments for active projects total \$580 million.

The World Bank's Country Assistance Strategy for fiscal years 2007-2010 envisages a lending program of up to US\$250 million per year. Azerbaijan is completing its first national poverty reduction program, and is now developing a new State Program for Poverty Reduction and Sustainable Development (SPPRS) for 2006–2015. The new Strategy reflects the objectives of the SPPRS and rests on four main pillars:

- *Improving the quality and transparency of public sector governance:* Maintaining a stable macroeconomic framework that makes prudent use of oil revenues; improving public expenditure planning and management; strengthening financial management and procurement systems; establishing proper public sector and corporate governance, accounting, and auditing; creating an administrative and regulatory environment conducive to growth; and strengthening the judicial system.
- *Supporting sustainable and balanced growth of the non-oil economy:* Expanding access to financial services; improving the business environment and, through IFC, providing direct investments and technical assistance to strengthen the private sector; developing essential infrastructure and services, with special attention to both the rural economy and Central Asia-South Caucasus-Black Sea regional transit routes; and, strengthening the financial viability and efficiency of the utility sectors.
- *Increasing the quality of and access to social services:* Expanding coverage of good-quality health care services; developing a modern education system and globally competitive knowledge economy; effectively targeting social assistance; creating a more transparent, affordable, and sustainable pension system; and improving living conditions and economic opportunities for internally displaced people.

- *Improving environmental management and furthering the climate change agenda:* Cleaning up legacy pollution, reducing carbon emissions, and promoting biodiversity; supporting more sustainable natural resource management in selected areas; and strengthening natural disaster management.

### **International Finance Corporation (IFC)**

Azerbaijan joined IFC in 1995. Since then, IFC has committed more than \$198 million of its own funds and has arranged over \$104 million in syndications. In 2004, IFC invested in the ACG Phase 1 oil field as part of a \$3.2 billion project to develop an oil field off Azerbaijan in the Caspian Sea. IFC also provided \$125 million of its own funds and helped mobilize another \$125 million for the Baku-Tbilisi-Ceyhan pipeline. IFC has invested in other key sectors, including oil and gas, food and beverage, finance and insurance, and hotel, hospitality, and tourism services.

IFC plans to continue to support local companies by building the capacity of financial institutions that serve SMEs. IFC helped expand availability of credit lines for small businesses and worked to establish the Microfinance Bank of Azerbaijan. In addition, IFC has invested in a regional equity investment fund, the CEAF Central Asia Small Enterprise Fund, which provides equity, quasi-equity, and debt financing to growth-oriented enterprises in the Central Asia region.

IFC's advisory work in Azerbaijan has focused on creating opportunities in the non-oil sectors. One of the main priorities for advisory services is building a strong financial markets infrastructure to support private sector and SME growth. Other program highlights include a leasing development project, an SME linkages program, corporate governance projects, as well as planned programs aimed at developing the housing finance market and improving the business enabling environment.

### **Asian Development Bank (ADB)**

Azerbaijan has received \$114 million in loan assistance since joining the Asian Development Bank (ADB) in 1999. ADB's operations in Azerbaijan are guided by the Interim Operational Strategy, which identifies two major areas for assistance: direct help to the poor, narrowly focused on internally displaced persons; and poverty reduction through non-oil sector development, particularly in the poorer regions. To ensure the sustainability of the Government's poverty fighting efforts, ADB has provided loans and technical assistance, including loans to rehabilitate water supply and sanitation facilities in regional towns, and a technical assistance to support the Government's efforts to prepare a long-term sustainable economic and social development strategy and program. A number of projects administered or directly funded by ADB have had significant impact in reducing poverty.

- ADB administered a \$2.5 million grant from the Japan Fund for Poverty Reduction (JFPR) for integrating internally displaced persons in Mingchevir city into society. The pilot project has made a substantial difference to living conditions by improving housing for more than 412 families and creating job opportunities. This has benefited more than 12,000 people, about 73 per cent of whom were poor.
- In 2003, a \$22 million loan from the Asian Development Fund was approved for works to protect 12 districts in four flood-prone areas, where poverty is significantly higher than the national average. Recurrent floods have pushed insurance premiums for personal coverage, crop damage, and loss of livestock beyond the reach of most people in the area. The project will protect five towns and 43 villages, and support the livelihoods of more than 200,000 people living on 76,790 hectares of floodplains. It will prevent an estimated \$4.83 million in annual losses due to flooding.
- In 2004, ADB approved two loans totalling \$30 million to provide residents, industries, and small businesses in three towns with improved water supply and sanitation services, which have deteriorated significantly in the years since Azerbaijan's independence. The project will upgrade aging infrastructure, bringing in private sector partners to help build distribution networks, reservoirs, chlorination facilities, waste stabilization ponds, sewers, and sewerage pumping stations. The project will benefit about 110,000 people.

- ADB has also provided advisory technical assistance for capacity building in the sector and administers a JFPR grant to rehabilitate residential water supplies and sanitation in the three towns. In 2005, ADB approved \$2.940 million in technical assistance grants and a \$1.5 million JFPR grant aimed at providing income-generating opportunities for poor rural households in Azerbaijan.
- In 2005, ADB approved two loans totalling \$52 million for the East–West Highway Improvement Project. The project will rehabilitate 127 kilometres of the Yevlakh–Ganja and Qazakh–Georgian border sections of the highway, as well as 65 km of connecting local roads, and support policy reform by strengthening institutional capacity in the sector. A project preparatory technical assistance was approved in 2005 to study the feasibility of another road improvement project.
- In 2006, ADB started its private sector activities and approved loans and equity investments to selected private commercial banks totalling \$15 million.
- ADB is supporting the energy sector with the approval of a technical assistance project to prepare the Renewable Energy Development Project, which examines the potential of wind, solar, and mini hydroelectric power to improve electricity supplies to regional towns.
- In 2007, ADB operations in Azerbaijan will focus on selected priority sectors: roads, water supply and sanitation, renewable energy, and the private sector, which are in line with the Government’s development priorities. ADB is currently working closely with the Government to process a Multitranches Financing Facility to help improve the road network.

### **Kreditanstalt für Wiederaufbau (KfW)**

Cooperation between KfW and Azerbaijan started in 1995. Up to and including 2006 the German federal government has committed a total of approximately €180 million for Azerbaijan under German Financial Cooperation (FC). Acting on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ), KfW is financing investments and accompanying advisory services. Most of the funds, roughly 85 per cent, are disbursed as low-interest loans with long terms, and a small portion is offered as non-repayable grants. Since 2001 bilateral development cooperation with Azerbaijan has concentrated mainly on the priority area of “sustainable economic development”. Additional financing in other sectors has since been provided under the Caucasus Initiative and the BMZ programme to promote renewable energies and energy efficiency. The aim of the Caucasus Initiative is to finance cross-border projects as a means of supporting economic, social and political development in the Southern Caucasus and thus to contribute to conflict reduction and crisis prevention in the region.

#### *Economic development sector*

- To date, €50 million in financing has been committed for programmes in this sector in Azerbaijan. KfW is focusing on promoting the finance sector. Through the German-Azerbaijani Fund, set up in 2000, six local banks are currently provided with refinancing, if they make this money available as loans for small and medium-sized enterprises (MSMEs).
- To ensure further targeted strengthening of the finance sector, KfW has also participated in the Microfinance Bank of Azerbaijan, which was founded in 2002.
- The Loan Guarantee Fund programme, for which KfW has provided €1 million in financing, is pursuing two goals. First, the fund is intended to make it possible for local banks to use international capital market funds as default guarantees for loans from international commercial banks. Second, these funds are then intended to be used to expand the still insufficient access to loans for MSMEs.
- In addition to the various programmes to provide loans for MSMEs, German FC is giving advice to four partner banks on improving their retail banking business. This includes establishing efficient working procedures in branches, providing further training for decision-makers and setting up banking networks.

- In addition, KfW is providing €5 million in support for the development of a deposit insurance system. Such a system effectively protects the deposits of small savers, strengthens their confidence in the banks and thus stabilises the financial markets.
- A total of €3 million is available for establishing and modernising an integrated property and land registry in Azerbaijan. This promotes the development of the property market, creates security about who actually owns land and makes management viable. In addition, accurate and up-to-date data make it possible to improve land planning.
- In addition to these activities, DEG, a member of KfW, is also financing projects suitable for promotion under development cooperation in Azerbaijan. It is currently supporting Bank Respublika and UniBank in Baku with equity or loans and is thus helping to strengthen the activities in the financial sector.

#### *Energy sector*

- The two energy projects in the initial phase of Financial Cooperation focus on the rehabilitation of transformer stations in and around the economic centre of Baku and in the north of the country. Their total volume is around €30 million.
- The latest project in this sector is the financing of the planned construction of a new transmission line that is roughly 150 km long and stretches from AzDRES to Imishli.

#### *Municipal infrastructure sector*

- In the area of municipal infrastructure, €60.7 million has to date been committed for Azerbaijan. The focus is on rehabilitating water supply and sanitation facilities. The pilot location for the first project was Imishli, in the south of the country.

During the German-Azerbaijani government negotiations in August 2006 it was agreed that KfW will implement two new programmes in Azerbaijan. One of these is a housing modernisation programme to the total of €4 million. Qualified local commercial banks which offer loans for real estate purchase or modernisation will be able to be refinanced through KfW and will be supported professionally in this sector. The German Government through KfW will also support another programme “rural banking” to a total of €5 million. KfW aims to support local commercial banks so that they can be strengthened and encouraged to extend micro loans and loans to farmers in rural areas. In addition employees of the participating banks will be professionally trained in a special training programme.

### **United States Agency for International Development (USAID)**

USAID has invested a total of \$27.8 million up to end of 2006 primarily in the following four programmes:

- *Economic Growth (\$12.9 million, 46.4 per cent):* The core priorities over the medium term are to help the Government of Azerbaijan and the private sector to build the institutions that will allow for the productive investment of the country’s natural resource wealth while preserving macroeconomic stability. USAID supports those key areas of fiscal planning, particularly the development and implementation of public investment; public financial management and accountability; and greater access to credit for SMEs through better laws, regulation, training and capitalization. The current project to develop a Treasury Information Management System which automates treasury functions and will provide a platform for better public accountability of public revenues has been well received by the Ministry of Finance with the MOF contributing funding and in-kind contributions. USAID is strengthening the Government’s capacity to develop and implement sound infrastructure and social investments and to integrate those investments and the budget into a consistent macroeconomic framework. The Ministry of Economic Development has been an energetic partner in this endeavour. Banking laws and regulations are improving as is the central bank’s capacity for supervision of a banking sector that is expected to grow by 50 per cent per year over the medium term. USAID supported Non-Bank Financial Institutions expanded operations reaching \$63 million in outstanding portfolio in 2005, a 100 per cent increase from 2004. USAID offers technical assistance in agricultural production and agribusiness to promote a more competitive rural economy by improving market linkages and added value to agricultural production. In 2005 USAID-assisted enterprises achieved over \$2.3 million

in new trade and investment and over \$4.9 million in plant improvements. The South Caucasus Regional Water Initiative (DAI) seeks to improve water resources management through technical collaboration between Armenia, Azerbaijan, and Georgia.

- *Democracy (\$8.4 million, 30.1 per cent):* USAID provides technical assistance to promote and support free and fair elections; strengthen democratic political parties; empower civil society; establish and ensure media freedom and freedom of information; promote and advance anti-corruption reforms; and improve justice sector/legal framework. In 2005 USAID focused on creating conditions to ensure free and fair elections for municipal and parliamentary elections. To this end, USAID provided assistance on training political parties, domestic observer organizations; conducting a pilot exit poll during the municipal elections, training elections workers on the usage of invisible ink during the parliamentary elections, and conducting the national exit poll during the parliamentary elections. USAID encouraged free access to media, created the first digital frequency map of Azerbaijan's broadcasting spectrum for television and radio, and held trainings for lawyers and judges further advancing the legal profession. USAID's activities on anticorruption resulted in launching two anti-corruption legal advocacy centres. USAID is finalizing Azerbaijan's legal database aimed at improving free access to updated texts of all laws, decrees and normative acts adopted since Azerbaijan's independence in 1991. Two new democracy projects have been designed, competed, and commenced aimed at promoting civil society and community-level citizen participation. USAID will continue support to strengthen civil society, democratic political parties, improve legal framework, and assist with advancing anti-corruption reforms.
- *Health (\$3.8 million, 13.6 per cent):* USAID improves health services and practices through health care reform; better use of health resources; dissemination of information on healthy lifestyles, rights and responsibilities of the patient, and health care services. USAID is working closely with the Government in an effort to ensure systematic, institutionalized changes, with a focus on reproductive health/family planning, primary health care, child survival, emergency medicine, and health system strengthening. Technical assistance is being provided to the Ministry of Health to develop policy, legal and regulatory and financing reforms. Family planning curricula on counselling and infection prevention and peer education materials were developed for use in training of health providers and peer educators. Networks of local and district health departments, NGOs, communities, and the private sector are beginning to advocate with regional government for changes in family planning and reproductive health policy and services.
- *Training and Small Grants Program (\$2.8 million, 9.9 per cent):* The cross-cutting training and grants programs support and complement all USAID activities. Activities promote development of technical and managerial capacity of stakeholders, business and professional associations and NGO capacity through training and grants.

### **Japanese Official Development Assistance**

Since the establishment of diplomatic relations between Japan and Azerbaijan in 1992, the Government of Japan has extended a total of € 560 million to Azerbaijan in the form of grants, technical assistance and loans. A short summary is presented below:

- The Japan Bank for International Cooperation (JBIC) allocated 480 million Euros in the form of three concessional loans towards the refurbishment of two power plants. A series of projects have been implemented in order to modernise power generation and transmission facilities, improving the reliability of power supplies that serve the country's growing economy. In particular, the latest loan, signed in 2005, was for the Shimal Gas Combined Cycle Power Plant Project, which aimed to utilise natural gas more efficiently and reduce air pollution through substantial reductions in CO<sub>2</sub> and SO<sub>x</sub> emissions.
- The majority of Japanese grant aid programs have focused on social dimensions such as health, community- level education and rural development, as a part of the Azeri's efforts to mitigate the rural- urban divide and to diversify the country's economic base. In 2006, Japan also

funded a project aimed at making improvements to the Mushiviq Substation in Baku and stabilising the power supply to a large part of Baku.

- Technical cooperation through the Japan International Cooperation Agency (JICA) have focused on capacity building in Azerbaijan through training in administrative functions such as fiscal management and planning, and through feasibility studies of local transport sectors and environment management in recent years.

### **Italy**

Between 2002-2005, in addition to assistance in the field of election monitoring channelled through OSCE, Italy focused its initiatives in the health sector. In 2006, aid for refugees was also delivered. The overall amount of assistance is around €1 million.